(1) 89- 1455

SUPREME COURT, U.S.
FILED
FEB 26 1990
JOSEPH F. SPANIOL, JR.
CLERK

In The Supreme Court of the United States

October Term, 1989

TRAGER, GLASS & COMPANY,
Petitioner,

vs.

JOSEPH M. NEWMYER, JOHN W. KWIATKOWSKI,
JOHN C. COLLINS and TOBIN R. COLLINS,
Respondents,

TRAGER, GLASS & COMPANY,
Petitioner,

vs.

EDWARD O'CONNELL,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

PETITION FOR WRIT OF CERTIORARI

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33 p/p

QUESTIONS PRESENTED

I.

GIVEN THE CONFLICT OF AUTHORITIES FROM THE CIRCUIT COURTS OF APPEALS, MUST HORIZONTAL COMMONALITY BE ESTABLISHED TO MEET THE *HOWEY* AND *FORMAN* "COMMON ENTERPRISE" COMPONENT OF THE TEST FOR DETERMINING WHETHER A TAX SHELTER INVESTMENT PROGRAM CONSTITUTES A "SECURITY", OR WILL VERTICAL COMMONALITY SUFFICE; IF HORIZONTAL COMMONALITY IS REQUIRED, DID THE SIXTH CIRCUIT COURT OF APPEALS PROPERLY APPLY THE TEST?

II.

IN MEETING THE *HOWEY* AND *FOREMAN* "REASONABLE EXPECTATION OF PROFITS" COMPONENT OF THE TEST FOR DETERMINING WHETHER A TAX SHELTER INVESTMENT PROGRAM CONSTITUTES A "SECURITY", MUST PROFIT AND NOT TAX ADVANTAGE HAVE BEEN THE PLAINTIFFS' *PRIMARY* MOTIVE?

III.

HAS THE *HOWEY* AND *FORMAN* REQUIREMENT OF PROFITS DERIVED "SOLELY FROM THE EFFORTS OF OTHERS" COMPONENT OF THE TEST FOR DETERMINING WHETHER A TAX SHELTER INVESTMENT PROGRAM CONSTITUTES A SECURITY BEEN SATISFIED IN THESE CASES, GIVEN THAT ALL CLOSING DOCUMENTS SHOW THE CRUCIAL ROLE OF PLAINTIFFS' *OWN* EFFORTS?

PARTIES TO THE PROCEEDINGS IN THE SIXTH CIRCUIT

The following parties were active in proceedings in the Sixth Circuit appeal which defendant Trager, Glass & Company seeks to bring before this court via Petition for Writ of Certiorari:

JOSEPH NEWMYER — Plaintiff

JOHN W. KWIATKOWSKI — Plaintiff

JOHN C. COLLINS and TOBIN R. COLLINS — Plaintiffs

EDWARD O'CONNELL — Plaintiff

TRAGER, GLASS & COMPANY[1] — Defendant

FRIEDMAN & SHAFTON, P.C. — Defendant

BOELTER, HOPT & GALE — Defendant

ROBERT V. YEO, JR. — Defendant

Other parties identified as defendants in these cases have either not filed Appearances in the Sixth Circuit, have not appeared in the District court, or are presently unrepresented by counsel in these proceedings and are subject to a bankruptcy stay.

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[1] Pursuant to disclosure required under Rule 28.1, Trager, Glass & Company has no subsidiaries, affiliates or parent companies.

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

The Petitioner, Trager, Glass & Company, asks that a Writ of Certiorari issue to review the Judgment and Opinion of the United States District Court of Appeals for the Sixth Circuit.

OPINIONS BELOW

The decision defendant seeks to appeal is reported as *Newmyer* v *Philatelic Leasing*, 888 F.2d 385, Fed. Sec. L. Repr. ¶94, 767; RICO Bus. Disp. Guide 7357 (6th Cir., 1989).

The decision of the trial court, District Judge Barbara Hackett, is reported as *Newmyer* v *Philatelic Leasing*, 1987 W.L. 47363 (E. D. Mi.), Fed. Sec. L. Rep. ¶93,671.

JURISDICTION

The jurisdiction of this court is sought under 28 U.S.C. §1254(1).

Defendant Trager, Glass & Company seeks review from the Opinion of the United States Court of Appeals for the Sixth Circuit, decided and filed October 20, 1989, and from the Opinion denying rehearing entered by the same court on November 27, 1989.

STATUTES INVOLVED

The statutory definition of "security" under the Securities Exchange Act of 1934 and the virtually identical definition under the Security Act of 1933 are involved in this litigation, 15 U.S.C. §78c(a)(10), 15 U.S.C. §77(b)(1). See text set forth within Petitioner's Appendix as entries A-1 and A-2.

STATEMENT OF THE CASE

The subject matter jurisdiction of the federal court in these cases is premised on federal question jurisdiction pursuant to 28 U.S.C. §1331. Plaintiffs each allege violations of §27 of the Securities Exchange Act of 1934 [including 15 U.S.C. §78aa and 78j (b)], of §17a of the Securities Act of 1933 [15 U.S.C. §771], and of the Racketeer Influenced and Corrupt Organizations Act [18 U.S.C. §1962].

Defendant/Petitioner Trager, Glass & Company asks this Court to grant its Petition for Writ of Certiorari to reverse the decision of the Sixth Circuit Court of Appeals relative to the securities law issues presented by this case. Review of the RICO issues is not sought.

The Sixth Circuit panel (J. Merritt, J. Nelson, J. Celebrezze) determined that Plaintiffs' investment in Defendant Philatelic Leasing's tax shelter program constituted investment in a "security". The Sixth Circuit panel reversed the Opinion of Judge Barbara Hackett of the Eastern District of Michigan, Southern Division, which had granted Defendants' Motion to Dismiss the securities claims. Judge Hackett had ruled that the lease transaction was not a security because there was no "common enterprise", and because there was no reasonable expectation of profits to be derived from the efforts of others.

In 1979, Crailheath Ltd. obtained the rights to produce postage stamps for certain Scottish islands (Newmyer Complaint, ¶27, with each such allegation repeated in the Complaint of companion plaintiffs). Crailheath transferred these rights to Global International, which then produced the necessary masters at an approximate cost of $1,000.00 per master (*Id.*, ¶28). Stamp masters are photographic color separations used for printing postage stamps and/or related ancillary products (Hersch Affidavit, ¶3). In May of 1982, Global sold to Hambrose Stamps Ltd. the right to produce up to 9,711 different stamp masters with the provision that only 75,000 stamps could be produced from each master (Id., ¶29).

In June of 1982, Hambrose agreed to sell Philatelic up to 9,500 stamp masters (*Id.*, ¶31). Philatelic purchased 830 stamp masters (*Id.*, ¶32) and proceeded to organize a network of salesmen and, allegedly, distributors (*Id.*, ¶¶33–34).

In 1982, Philatelic Leasing's offering memorandum was prepared. That memorandum included a tax opinion authored by Defendant Friedman & Shaftan and a Trager Glass letter offering to assist lessees in the event of IRS challenge (*Id.*, ¶36). Plaintiffs claim that the offering memorandum failed to disclose certain facts, *Id.* at ¶37.

Defendant Trager Glass is a private corporation of certified public accountants (Affidavit of Trager, attached as Exhibit 3 to Docket entry 2, *Newmyer*). Trager Glass' only act with respect to the matters complained of was the preparation of the one-page letter which was included within Philatelic's 72-page offering memorandum. The memorandum, along with a 50-page tax opinion letter setting forth the tax consequences of investing in the shelter, was prepared by the law firm of Friedman & Shaftan. Trager Glass' letter made no representations regarding tax benefits from lease of the stamp masters. It made no representations regarding the prospects of profit from the leases. In its entirety it stated:

> Philatelic Leasing, Ltd.
> 950 Third Avenue
> New York, NY 10022
>
> Gentlemen:
>
> This is to confirm that in the event that the Internal Revenue Service or any tax agency challenges the tax structure of the transaction set forth in your Information Memorandum, dated September 1982, we have agreed to assist you in defending such challenge.
>
> Upon request by a lessee, we will assist their counsel and accountants if the Internal Revenue Service or any

> local tax agency challenges the tax structure of the transaction as set forth in the Information Memorandum and the lessee is unable to reach a satisfactory resolution at the initial audit level. Such assistance would include advice in connection with their appearances before the appellate division of the Internal Revenue Service. We would also be available to assist the lessee's counsel in defense before the U.S. District Court, U.S. Tax Court or the U.S. Court of Claims.
>
> Very truly yours,
>
> Trager, Glass & Company, CPA's, P.C.
> Lawrence Trager.

The uncontradicted Affidavit of Lawrence Trager of Trager Glass was submitted to the trial court. It attests to Trager Glass' noninvolvement in the preparation of the offering memorandum.

Each plaintiff claims that he was first exposed to the stamp master program via Defendant Robert Yeo, *Id.* ¶38. Yeo allegedly told plaintiffs that they would reap substantial tax benefits, that the shelter was a sound one, and that the lessees would be entering into a profitable business, *Id.* ¶39. Yeo gave plaintiffs copies of appraisals regarding the marketability of the stamps, *Id.* ¶40. He gave each plaintiff a copy of the Confidential Offering Memorandum, allegedly as proof that the shelter would pass IRS scrutiny, *Id.* ¶41. Allegedly as further proof of the ability to withstand IRS scrutiny, Yeo also gave each plaintiff a copy of a newsletter from Defendant Boelter, Hopt and Gale, *Id.* ¶44. Allegedly, the newsletter misadvised readers and made statements that were erroneous regarding the Philatelic program, *Id.* ¶45.

Each plaintiff leased stamp masters from Philatelic Leasing. Each of the plaintiffs were entitled to print and market stamps and ancillary products for personal profit, *Id.*, ¶48. A stamp master leased to one plaintiff was not leased to other plaintiffs (or anyone else); no plaintiff had any interest in

any stamp master which Philatelic Leasing leased to other persons, Hersch Affidavit, ¶3.

As part of their lease, plaintiffs each signed documents which specified their financial and managerial responsibilities in detail, Hersch Affidavit, ¶4. True copies of the respective plaintiffs' leases and security agreements, lessee questionnaire and the Confidential Information Memorandum were attached as exhibits to the Hersch Affidavit. No plaintiff contested the genuineness of these documents.

Each lease and security agreement provided for lease payments to Philatelic over a seven year term via a combination of cash and recourse notes for the first year, a partial recourse note for the second year, and non-recourse notes for the balance of the lease period, *Id.* at ¶5.

The Confidential Information Memorandum required that each lessee handle his own distribution and sale of stamps. See page 21:

> Distribution and sale of the stamps and ancillary products will be arranged solely by the lessee at his expense. For this purpose, a lessee may, for example, employ one or more distributors as his agent for the distribution and sale of the stamps and ancillary products, in which case the lessee will be responsible for the attendant fees and costs. Neither Hambrose nor Philatelic will designate or recommend distributors, but Philatelic will furnish a lessee, at his request, with a list of distributors known to the lessor.

Each of the plaintiffs' obligations with respect to stamp distribution and ancillary products was explained within the Confidential Information Memorandum, see page 11:

> Once [the stamps] are produced from the stamp master, the lessees must distribute them. Some lessees may elect to handle this task on their own. However, the vast majority of lessees are likely to select an established distribution company. There are a number of such companies

readily available and willing to handle the distribution of quality topical stamps. Philatelic cannot be a party to negotiations with these distributors.

Dell Philatelic Consultants Ltd., the distributor selected at least by Newmyer, John and Tobin Collins and Kwiatkowski (see Plaintiffs' Affidavits filed in the lower court), was not in any way affiliated or related to Philatelic, Hersch Affidavit, ¶9. Philatelic and Dell had no common officers, directors, employees or shareholders, office space was not shared, and Philatelic was not related to Dell in any way, *Id.* Philatelic did not recommend that plaintiffs enter into contracts with Dell and was not a party to plaintiffs' agreements with Dell, *Id.* The affidavit testimony of Hersch was never disputed by plaintiffs.

Each of the plaintiffs took tax deductions for the years 1980 through 1983. Each plaintiff received an IRS notice challenging these deductions, (*Newmyer* Complaint, ¶55).

ARGUMENT

CERTIORARI SHOULD BE GRANTED TO DETERMINE WHETHER A TAX SHELTER INVESTMENT PROGRAM CAN BE HELD A "SECURITY" SUBJECT TO REGULATION UNDER THE FEDERAL SECURITY ACTS. THE NATURE OF THE REQUIRED COMMON ENTERPRISE (HORIZONTAL OR VERTICAL) SHOULD BE RESOLVED BY THIS COURT AND PROFIT FROM THE ENTREPRENEURIAL OR MANAGERIAL EFFORTS OF OTHERS AS A REQUIRED PRIMARY MOTIVE SHOULD BE MORE CLEARLY ARTICULATED.

A. This court has established general guides which inform the definitional parameters of the concept of a "security".

The securities legislation was remedial in nature and the term "security" must therefore be "construed broadly to

effectuate [the Acts'] purpose", and a "narrow or restrictive" definition would be contrary to Congressional intent. *Tcherpenin* v. *Knight*, 389 U.S. 332, 338; 88 S. Ct. 548, 554 (1967). However, in enacting the securities laws, Congress " . . . did not intend to provide a broad federal remedy for all fraud", *Marine Bank* v. *Weaver*, 455 U.S. 551, 556; 102 S. Ct. 1220, 1223 (1982).

The term "security" " . . . embodies a flexible rather than a static principle, one that is capable of adaption to meet the countless and variable schemes devised by those who seek use of the money of others on the promise of profit", *S.E.C.* v. *W.J. Howey*, 328 U.S. 293, 299; 66 S. Ct. 1100, 1103 (1946). The reach of the term " . . . does not stop with the obvious and commonplace", *S.E.C.* v *C.M. Joiner*, 320 U.S. 344, 351; 64 S. Ct. 120, 123 (1943). "[F]orm should be disregarded for substance and the emphasis should be on economic reality", *Tcherpenin*, 389 U.S. 332, 336; 88 S. Ct. 553. Resolution should " . . . turn on the economic realities underlying a transaction, and not on the name appended thereto", *United Housing Foundation, Inc.* v *Forman*, 421 U.S. 837, 849; 95 S. Ct. 2051, 2059 (1975). However, the "name" assigned a transaction is not " . . . wholly irrelevant to the decision whether it is a security", *Forman*, *Id.*, at 850; 2059.

As to investment contract-type securities, courts must evaluate transactions according to the "commonly held understanding of an investment contract", *International Brotherhood of Teamsters* v *Daniel*, 439 U.S. 551, 559; 99 S. Ct. 790; 796 (1979). The securities laws should not be applied to a transaction absent " . . . characteristics that in our commercial world fall within the ordinary concept of a security", *Forman*, 421 U.S. 851; 95 S. Ct. 2060.

The general guides do little to aid resolution of this vexed question of what is, or is not, a "security" as applied to the particular transaction defendant Trager Glass seeks to bring before this court. Judge Knapp, in his opinion granting injuctive relief to the government against Philatelic Leasing and

the promoters of what was determined to be an abusive tax shelter under The Tax Equity and Fiscal Responsibility Act of 1982, 26 U.S.C. 6700 *et seq.*, detailed the nature of the present transaction:

> [W]e are concerned only with tax advantage investment programs ("shelters") which are created by the device of having the provider of the shelter lease supposedly productive assets — here, "stamp masters" — to taxpayers in circumstances where the lessor passes his investment tax credit (ITC) on to the taxpayer so that the latter can use it in reducing his tax liability. The lessor's ITC (which is passed on to the taxpayer) is based on its own cost in acquiring the asset. *U.S.* v *Philatelic Leasing*, 601 F. Supp. 1554, 1554 (S.D. N.Y., 1985) *aff'd* 794 F.2d 781 (2nd Cir., 1986)

The economic realities?

> By combining tax credits and deductions, the Philatelic 1982 shelter conferred, in tax shelter parlance, a "4 to 1 equivalent write-off". That is to say, a taxpayer would receive tax benefits four times greater than his actual cash outlay. *U.S.* v *Philatelic Leasing*, 794 F.2d 781, 782 (2nd Cir., 1986)

B. The Circuits are in conflict in interpreting this court's opinions defining an investment contract-type security, leading to unpredictability in outcome even as to identical or substantially similar transactions.

The opinions of this court offer specific guidance to the Circuits on the definition of an investment contract-type security. As will be seen, however, the Circuits are in conflict in interpreting this court's decisions. In fact, the Circuits have been in conflict on these issues for many years. The lease of "masters" (stamps, artworks, records . . .) litigation demonstrates what chaos rules.

The Sixth Circuit has informed the Michigan plaintiffs that, depending on factual developments the court apparently anticipates, they may very well have invested in securities when they leased their stamp masters in order to claim the 4–1 write-off. The Hawaii District Court in *Nakagawa* v *Ellis & Ellis*, Fed. Sec. L. Rptr. (CCH), ¶93,028 (1987) informed the similarly-situated Hawaiian plaintiffs that the Philatelic Leasing investment was *not* a security. This was also the conclusion of the Tennessee District courts which dismissed plaintiffs' claim in *Lakshmikanth* v *Philatelic Leasing*, No. 3-83-0710 (D. Tenn. 1983) and in *White* v *Philatelic Leasing*, 1987 W.L. 49640 (E.D. Tenn.) and of the Washington District Court in *Routh* v *Philatelic Leasing*, 1988 W.L. 161240 (E.D. Wash.); Blue Sky L. Rep. ¶72,707; Fed. Sec. L. Rep. ¶93,672. See also, *Bausch* v *Philatelic Leasing*, 1990 W.L. 3613 (D. Md.) reciting, see Westlaw page 3, that the Motion to Dismiss the securities fraud claims had been previously granted. Apparently the Michigan Sixth Circuit plaintiffs will be advantaged as compared to their peers in other jurisdictions.

Defendant Finesod, inactive in this litigation, is also a principal in an art masters lease tax shelter which bears great similarity to the Philatelic stamp masters program. In *Wells* v *Jackie Fine Arts*, 1987 W.L. 140912 (S.D. Ohio) and in *Faircloth* v *Jackie Fine Arts*, 682 F. Supp. 837 (D. S.C. 1988), the transactions were deemed *not* to be securities. In accord see *Dahl* v *English*, 578 F. Supp. 17 (N.D. Ill., 1983) [the sale of artworks in lithographic plate form not a security]. However, a lease of recording masters, again a tax shelter and again indistinguishable from the present case in terms of structure, was deemed a security in *Kolibash* v *Sagittarius Recording*, 626 F. Supp. 1173 (S.D. Ohio, 1986). The same type of master recording leases were found *not* to constitute securities in *Fabiano* v *Kessler*, No. C-2-84-1623 (S.D. Ohio, 1986).

C. This court's decisions in *Howey, Forman* and their progeny, require demonstration of horizontal commonality (involving a pooling of investments and a pro rata profit share) and profit as a primary motive. Certiorari should be granted to clearly articulate these standards.

The definitional parameters of an "investment contract" have been concisely stated by this court, first in *Howey, supra*, at 328 U.S. 301; 66 S. Ct. 1104, next reiterated in *Forman, supra*, at 421 U.S. 852; 95 S. Ct. 2060:

> We perceive no distinction, for present purposes, between an "investment contract" and an instrument commonly known as a "security". In either case, the basic test for distinguishing the transaction from other commercial dealings is:
>
> > "Whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others" *Howey*, 328 U.S. at 301.
>
> This test, in shorthand form, embodies the essential attributes that run through all of the Supreme Court decisions defining a security.

"The touchstone [of the *Howey* test] is the presence of an [1] investment in a [2] common venture [3] premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others", *Forman, supra*, at 421 U.S. 852; 95 S. Ct. 2060; *Daniels, supra*, at 439 U.S. 561; 99 S. Ct. 797.

In *Howey*, the defendant owned large tracts of citrus acreage and offered to sell narrow strips. Those who purchased the strips were to receive Warranty Deeds to the property. They were given the option, but were not required, to lease their land to a service company controlled and managed by the same people who controlled the defendant/seller. Eighty-five (85) percent of the buyers elected this option to cultivate

the land and harvest and market via the service contract. The small size of the plots rendered individual development economically unfeasible, *Howey, supra* at 328 U.S. 300; 66 S. Ct. 1103. "Such tracts gain utility as citrus groves only when cultivated and developed as component parts of a larger area", *Id.* In *Howey,* all the produce was pooled by the companies, who were "accountable only for an allocation of the net profit . . . ", *Id.* at 296; 1102. The investors gained or lost — together — and their enterprise was a common one.

The purchasers in *Howey* were persons residing "in distant localities who lack the equipment and experience requisite to the cultivation, harvesting and marketing of the citrus products", *Id.* at 300; 1103. Such persons " . . . are attracted solely by the prospects of a return on their investment", *Id.* The profits they so single-mindedly sought clearly derived solely from the efforts of others. The transaction was deemed a security.

The enterprise at issue in *Forman* was not one held reasonably calculated to produce profits. The question in *Forman* was whether the statutory definition of securities included buying shares entitling the purchaser to lease an apartment in a state-subsidized and supervised not-for-profit cooperative housing program. The majority answered the question, "No". In the process, the Supreme Court presented its most comprehensive analysis of an investment contract type security. The *Forman* court cited "common sense" and the lack of the usual features associated with stock ownership (e.g. voting rights, ability to be pledged, ability to appreciate in value) as suggesting that the persons who bought such "stock" must have lacked a profit motive, *Forman, supra,* at 421 U.S. 851; 95 S. Ct. 2060:

> In short, the inducement to purchase was solely to acquire subsidized low-cost living space; it was not to invest for profit.

In the absence of economic profit motive, i.e. where people are seeking housing, as in *Forman*, or seeking tax advantage, as in the present cases, security status will be denied.

Like the plaintiffs in the present case, favorable tax benefits were conferred upon the purchasers. The majority explained, *Forman* at 421 U.S. 855; 95 S. Ct. 2060:

> We know of no basis in law for the view that the payment of interest, with its consequent deductibility for tax purposes, constitutes income or profits. These tax benefits are nothing more than that which is available to any homeowner who pays interest on his mortgage.

In accord, see *Randall* v *Loftsgaarden*, 478 U.S. 647, 657; 106 S. Ct. 3142, 3150 (1986)[2].

The *Forman* court was resolute in its view that no profits were demonstrated, despite the fact that there was " . . . the possibility of net income derived from the leasing of . . . commercial facilities, professional offices and parking spaces and [the] leasing of community washing machines", *Id.* Such income was used to directly reduce tenant rental costs, but the *Forman* court saw such potential income as too inconsequential and too speculative to supply a proper profit motive. Security status was denied:

> Conceptually, one might readily argue that net income from the leasing of commercial and professional facilities is the kind of profit traditionally associated with a security investment. °°° But in the present sense this income — if indeed there is any — is far too speculative and insubstantial to bring the entire transaction within the Securities Acts. *Forman, supra*, at 421 U.S. 856; 95 S.Ct. 2062.

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[2] *Randall* rejects the argument that the tax deductions petitioners were entitled to take by virtue of their partnership interests constituted income or profits. Tax deductions or tax credits "have no value in themselves" because the benefit arises only when such deductions are offset against income derived from other sources or when tax credits are used to reduce taxes otherwise payable on account of such income.

The "possibility" of rent reduction was not viewed as an expectation of profit in the sense found necessary in *Howey*, see *Forman*, 421 U.S. 857; 95 S. Ct. 2063.

As criticized by the dissenters in *Forman*, the majority held that only two forms of "profit" would be sufficient to supply status as a security: (1) the appreciation of capital or, (2) the participation in earnings, *Forman*, *supra*, at 421 U.S. 863; 95 S. Ct. 2066 (dissent). The majority explained its view; *Forman*, at 421 U.S. 852; 95 S. Ct. 2060:

> By profits, the court has meant either capital appreciation resulting from the development of the initial investment, as in *Joiner*, *supra*, (sale of oil leases conditioned on promoters' agreement to drill exploratory well), or a participation in earnings resulting from the use of investors' funds, as in *Tcherepnin* v *Knight*, *supra* (dividends on the investment based on savings and loan association's profits). In such cases the investor is "attracted solely by the prospects of a return" on his investment. *Howey*, *supra*, at 300.

The majority concluded there could be "no doubt" but that " . . . investors were attracted solely by the prospect of acquiring a place to live, and not by financial returns on their investment", *Forman*, *supra*, at 421 U.S. 853; 95 S. Ct. 2061.

This Court's effort to define a security, in part by reference to profits derived from the efforts of others, was continued in *International Brotherhood of Teamsters* v *Daniels*, 439 U.S. 551; 99 S. Ct. 790 (1979). *Daniels* reversed a Seventh Circuit opinion which had held that an employer-contribution pension fund constituted an "investment contract"-type "security" within the scope of the federal securities acts. As in *Forman*, this court again emphasized the lack of any dominant or primary profit motive, *Daniels*, *supra*, at 439 U.S. 560; 99 S. Ct. 797:

> [The employee] surrenders his labor as a whole, and in return receives a compensation package that is substantially devoid of aspects resembling a security. His decision

> to accept and retain covered employment may have only an attenuated relationship, if any, to perceived investment possibilities of a future pension. Looking at the economic realities, it seems clear that an employee is selling his labor primarily to obtain a livelihood, not making an investment.

Though the pension fund in *Daniels* depended in part on the managerial efforts of the Fund's managers, the greater share of the income came from new contributions. The transaction was beyond the scope of the federal securities statutes. This was so, in part, because profit could not be demonstrated given: (1) the lack of a primary profit motivation and (2) the speculative, insubstantial nature of any expectation of profit, *Daniels, Id.* at 439 U.S. 562, 99 S. Ct. 798:

> Even if it were proper to describe the benefits as a "profit" returned on some hypothetical investment by the employee, this profit would depend primarily on the employee's efforts to meet the vesting requirements, rather than on the fund's investment success. When viewed in light of the total compensation package an employee must receive in order to be eligible for pension benefits, it becomes clear that the possibility of participation in a plan's asset earnings "is far too speculative and insubstantial to bring the entire transaction within the Securities Acts", *Forman*, 421 U.S., at 856.

Marine Bank v *Weaver*, 455 U.S. 560; 102 S. Ct. 1220 (1982) sheds additional light on the definition of a security via the court's examination of the common enterprise prong. The transaction involved the Weavers, who purchased a $50,000 certificate of deposit from a bank, then pledged that certificate to the same bank to guarantee a loan to a company already $33,000 in debt to the bank on prior loans. The Weavers, in turn, were to receive 50% of the Company's net profits. The company went bankrupt soon after the Weavers guaranteed the loan and the bank then laid claim to the pledged certificate of deposit. The Weavers claimed the bank

withheld material information from them and they sought remedies under the securities statutes.

The Weavers' claim to security status for the transaction was rejected by this court. The unique nature of the agreement, negotiated one-on-one by the parties, and the fact that no public trading was involved was emphasized, *Marine Bank, supra*, at 455 U.S. 559-560; 102 S. Ct. 1225. Implied in this court's treatment was that there must be an investor-to-investor relationship [horizontal commonality] before a security will be said to exist. Mere investor-to-promoter relationships [vertical commonality] will fall short of establishing the common enterprise, see in accord on this interpretation of *Marine Bank*, *First National Bank* v *Thoele*, Fed. Sec. L. Rptr. (CCH), ¶98,854 (1982).

The three justices (Burger, White and Brennan) who dissented and urged that certiorari be granted in *Mordaunt* v *Incomco*, 469 U.S. 1115; 105 S. Ct. 801 (1985) believed that the issue of horizontal vs. vertical commonality, in connection with demonstrating a common enterprise, remained an open question. The various Courts of Appeals, now split on the question, have regarded the issue as a matter not yet settled by this court.

Arnold S. Jacobs, *Litigation and Practice Under Rule 10b-5*, §38.03(b)(iii) succinctly explains the differences between horizontal and vertical commonality:

> Under horizontal commonality, the plaintiff-investors must pool their investments, and courts usually also require that they share profits pro rata. Vertical commonality allows an investor's relationship either with the promoter or with the other investors to satisfy the "common venture" requirement; the investor therefore need not have any relationship with any other investor.

"Vertical commonality does not necessitate a pooling of investments, interdependence of the investors, or a pro rata sharing of profits. It follows that a plaintiff can more easily satisfy vertical commonality than horizontal commonality", Jacobs, *Id.*

Jacobs reports that the Fifth[3], Ninth[4], Tenth[5], and Eleventh[6] Circuits have endorsed vertical commonality. Horizontal commonality is endorsed by the Third[7], Sixth[8]

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[3] *Long* v *Shultz Castle*, 881 F.2d 129, 140 (5th Cir., 1989) ["This court . . . has explicitly rejected the view that horizontal commonality is a prerequisite to establishing a common enterprise within the meaning of *Howey* and has focused instead on the 'vertical commonality' between the investors and the promoters."]; *SEC* v *Koscot*, 497 F.2d 473, 478-79 (5th Cir., 1984) ["The critical factor is not the similitude or coincidence of investor input, but rather the uniformity of impact of the promoter's decisions"]; *SEC* v *Continental Commodities*, 497 F.2d 516, 522 (5th Cir., 1974).

[4] *Hocking* v *Dubois*, (en banc) 885 F.2d 1449, 1459 (9th Cir., 1989), petition for cert. filed December 19, 1989, #89-1023. [With horizontal commonality, "The participants pool their assets; they give up any claim to profits or losses attributable to their particular investments in return for a pro rata share of the profits of the enterprise; and they make their collective fortunes dependent on the success of a single common enterprise", noting the Ninth Circuit accepts the sufficiency of " . . . either traditional horizontal commonality or, when no pooling among investors is present, a strict version of vertical commonality"]; *SEC* v *Glenn W. Turner*, 474 F.2d 476, 482 n.7 (9th Cir., 1973) cert den. 414 U.S. 821 (1974) ["A common enterprise is one in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties".]

[5] *McGill* v *American Land & Exploration*, 776 F.2d 923, 925 (10th Cir., 1985) ["The rigid horizontal commonality requirement . . . has never been a part of the law of this circuit"]; *Woodward* v *Terracore*, 574 F.2d 1023, 1025 (10th Cir., 1978).

[6] *Villeneuve* v *Advanced Business Concepts*, 698 F.2d 1121, 1124 (11th Cir., 1983).

[7] *Salcer* v *Merrill, Lynch, Pierce, Fenner and Smith*, 682 F.2d 459, 460 (3rd Cir., 1982) [In answering the question of whether a commodity account was a security, the court held *Howey* unsatisfied "because such an account is not an investment in a common enterprise" given that the investment "was not a part of a pooled group of funds"]; *Wasnowic* v *Chicago Bd of Trade*, 352 F. Supp. 1066, 1068 (M.D. Pa., 1972) aff'd 491 F.2d 752 (3rd Cir.) cert. denied 416 U.S. 994; 94 S. Ct. 2407 (1974).

[8] *Deckebach* v *LaVida Charters*, 867 F.2d 278, 281 (6th Cir., 1989) ["We specifically rejected the vertical commonality approach adopted by the Second, Fifth, and Ninth Circuits . . . The more liberal vertical commonality approach . . . effectively excises the common enterprise requirement from *Howey*. Without some link between multiple investors***would in trust mean the adoption of an expansive 'risk capital' approach that would effectively transform *Howey* into a two part, rather than a three part, test"; *Union Planters Nat'l Bank* v *Commercial Credit Business Loans*, 651 F.2d 1174, 1183 (6th Cir., 1981) cert. denied 454 U.S. 1124, 102 S. Ct. 972 (1981) ["A horizontal common enterprise . . . requires a heightened degree of affiliation. Horizontal commonality ties the fortunes of each investor in a pool of

and Seventh[9], *Id.* The Ninth Circuit operates under what that Court of Appeals, sitting en banc recently in *Hocking* v *DuBois*, 885 F. 2d 1449 (9th Cir., 1989) described as "a strict version of vertical commonality", *Id* at 1459. In the Ninth Circuit, it is not enough " . . . that the promoter has control of the investments . . . [the Ninth Circuit] also requires a correlation between the success of the promoter and that of the accounts themselves", *Mordaunt* 469 U.S. 1116; 105 S. Ct. 802. While the Sixth Circuit is firmly committed to horizontal commonality, see *Deckebach* v *LaVida Charters*, 867 F.2d 278 (6th Cir., 1989) and *Curran* v *Merrill, Lynch*, 622 F.2d 216 (6th Cir., 1980), aff'd other grounds, 456 U.S. 353, 102 S. Ct. 1825 (1982), the proper application of the test grows confused with the present opinion.

The three Justices writing in favor of granting Certiorari in *Mordaunt, supra*, a commodities futures contracts case, described the horizontal/vertical conflict existing in the Circuits in 1985:

> The importance of this conflict is not limited to the classification of discretionary commodities futures contracts. In related areas the lower courts are similarly divided as to whether *Howey* requires vertical or horizontal commonality. For example, the Ninth Circuit relied on its decision in this case in concluding that vertical commonality rendered a sale leaseback transaction a security. *United States* v *Jones*, 712 F.2d 1316 (9th Cir.,

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investors to the success of the overall venture . . . . A requirement of horizontal commonality best comports with the language of *Howey*, because in a common enterprise all investors must share a common fortune]; *Curran* v *Merrill, Lynch, Pierce, Fenner and Smith*, 622 F.2d 216, 222 (6th Cir., 1980) aff'd other grounds 456 U.S. 353, 102 S. Ct. 1825 (1982).

[9] *Stenger* v *R.H. Love Galleries*, 741 F.2d 144, 146 (7th Cir., 1984) ["This Circuit has strictly adhered to a horizontal test of common enterprise, under which multiple investors must pool their investments and receive pro rata profits". This is in contrast to vertical commonality, in which "the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment"]; *Milnarik* v *M-S Commodities*, 457 F.2d 274, 278 (7th Cir., 1972) cert. denied 409 U.S. 887; 93 S. Ct. 113 (1972).

1983) cert. denied, 434, 78 L.Ed.2d 366 (1983). In contrast, the Sixth Circuit has relied on *Curran, supra,* in applying a horizontal commonality test to a loan participation agreement. *Union Planters National Bank of Memphis* v *Commercial Credit Business Loans,* 651 F. 2d 1174 (6th Cir., 1981) cert. denied, 454 U.S. 1124, 102 S. Ct. 972, 71 L.Ed.2d 111 (1981).

Mordaunt, supra, at 469 U.S. 1116; 105 S. Ct. 803.

Justice White, joined by Chief Justice Burger and by Justice Brennan, concluded that certiorari should be granted " . . . in light of the clear and significant split in the Circuits" on the question of horizontal vs. vertical commonality, *Mordaunt* at 1117; 302.

Since 1985, the split in the Circuits has grown more clear, and more significant, with hints (as in this case) that even horizontal commonality is now developing splinter theories. The necessity for clarity about what constitutes a "security" subject to federal securities law regulation grows more urgent in the present era. The Circuits and the regulatory agencies need this court's guidance. The present case provides the court with an excellent vehicle for articulating the proper standards for determining what must be demonstrated before a transaction can properly be characterized as a security.

D. Though correctly determining that horizontal rather than vertical commonality must apply, the Sixth Circuit erred in concluding that horizontal commonality could be demonstrated by reference to marketing efforts by defendant Dell which conceivably could have produced sales of the stamps or by Philatelic's commitment to take actions in support of the tax shelter which might benefit the investors as a group.

Plaintiffs each leased different stamp master printing plates from defendant Philatelic Leasing. The uncontradicted affidavit

of Hersch (Sixth Circuit Joint Appendix, p. 207) established that each plaintiff was entitled to print and market his stamps and ancillary products made from his stamps for his own profits and that none of the plaintiffs had any interest in the stamp masters which Philatelic leased to other persons.

The facts do not indicate a pooling of investors' funds. Failing this classic litmus test for demonstrating horizontal commonality, the panel reasoned primarily from the fact that three of the four plaintiffs had signed distribution contracts with Dell Philatelic Consultants (Opinion Denying Rehearing, 888 F.2d 399), i.e. "most" (888 F.2d 396) plaintiffs, and from plaintiffs' claims of conspiracy between Philatelic, Dell and Yeo. Per the panel, the Dell contracts and claims of concerted action, if demonstrated by plaintiffs, would be sufficient to supply the common enterprise requirement by demonstrating horizontal commonality. The court's analysis belies the undisputed factual record.

Dell was not related to Philatelic:

> Dell is not in any way affiliated with or related to Philatelic Leasing, Ltd. Dell and Philatelic Leasing, Ltd. have no common officers, directors, employees and shareholders; do not share office space; and are not related to each other in any way. Philatelic is not a party to the agreement between plaintiff and Dell. Philatelic did not recommend that plaintiff enter into his contract with Dell.

(Hersch Affidavit, ¶9; Sixth Circuit Joint Appendix, p. 212). The plaintiffs give differing accounts of their dealings with Dell, some claiming that Yeo recommended Dell, but plaintiffs

do not dispute Hersch's sworn statement that Philatelic did not recommend Dell.[10]

The Sixth Circuit concluded that: "If the plaintiffs in the instant cases can show a common enterprise among defendants Yeo, Philatelic and Dell, it would be a relatively simple matter for the plaintiffs to satisfy the horizontal commonality test", 888 F.2d 396. Assuming facts not in evidence, i.e. that the 1600 designs of stamps "were not more or less fungible", *Id.* at n.7, the panel saw " . . . no reason to suppose" that the marketability of the stamps varied from plaintiff to plaintiff. Thus:

> [I]t is entirely possible that if Dell had used the plaintiffs' money to advertise or otherwise promote these local stamps, developing a real market for them, all of the plaintiff investors would have benefited just as all of the investors in *Howey* stood to benefit from the service company's successful marketing of their oranges.

888 F.2d 396.

The effort to justify such a view by reference to *Howey* fails. In *Howey*, the service company and the owner of the citrus grove were "under direct common control and management", *Howey, supra*, 328 U.S. 295; 66 S. Ct. 1101. This contrasts with the present cases, given the undisputed fact that Philatelic and Dell were unrelated entities. Also, in *Howey*, all the produce was pooled by the two companies, who were then accountable to purchasers only for an allocation of the net profit, 328 U.S. 296; 66 S. Ct. 1102. Here, each lessee

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[10] Newmyer states, see Newmyer Affidavit, ¶6, Sixth Circuit Joint Appendix, p. 382, that "Yeo recommended Dell". Collins agrees with Newmyer and contends that "Dell Philatelic was recommended by Robert Yeo", see Collins Affidavit, ¶5, Sixth Circuit Joint Appendix, p. 370.

Kwiatkowski gave a different version, see Kwiatkowski Affidavit, ¶6, Sixth Circuit Joint Appendix, p. 376, contending that Yeo gave him a list of distributing companies, including Dell.

O'Connell did not submit any Affidavit (or other) testimony which set forth his relationship (if any) with Dell.

would only gain from the sale of his own identifiable stamps and there was no pooling of profits.

The Sixth Circuit concluded that horizontal commonality is supportable in these cases even if the plaintiffs fail to prove their claims of concerted action. Citing such marketing successes as "pet rocks, op art, anything remotely connected with the late Mr. Elvis Presley", 888 F.2d 396, the panel looked to lease agreements and informed that if the stamps were successfully marketed Philatelic "stood to receive far larger amounts under the lease", *Id.* Demonstrating horizontal commonality was allowed to turn on whether: "The fortunes of Philatelic were directly linked to the success or failure that the stamps enjoyed in the retail marketplace", *Id.*

Apparently the court's proposed link between hypothetical marketing success and demonstrating horizontal commonality is whether Philatelic was "committed to action that might benefit the investors as a group", *Id.* The Sixth Circuit emphasized that Philatelic was committed to paying the bulk of its receipts over to Hambrose, which might in turn have enhanced the actual value of the masters and provided a revenue production history to aid defense of the legitimacy of the tax shelter. The panel rejected plaintiffs' arguments that the expectation of favorable tax benefits could supply the profit prong of the definition of security, yet in a strange twist allowed such thinking to stand as potentially determinative of the common enterprise analysis. The Sixth Circuit almost invited this court's review, 888 F.2d 397:

> Like the contention that horizontal commonality can be shown through Philatelic's commitment to defend the tax structure in court, the argument depends on the conclusion that a pooling of interests in the hope of securing tax benefits will satisfy the commonality requirement even though it cannot, by itself, satisfy the expectation of profits requirement. Where the Supreme Court would come out on this question — assuming the court agrees with us that horizontal commonality must be shown — we do not know.

The court felt it need not "come to grips" with the issue, given the claims of concerted activity between Dell, Philatelic and Yeo, but the issue was nevertheless treated extensively in the opinion, 888 F.2d 396-397.

While purporting to apply horizontal commonality, the panel in this case actually used a vertical test by finding a common enterprise would exist if each lessee's fortunes were interwoven and dependent upon the efforts of the promoter (Philatelic) and third parties (Dell and Yeo). Regardless of whether certain of the defendants acted in concert, horizontal commonality is not demonstrated here. Each plaintiff's profits were tied to how well each plaintiff's own stamps sold. That Philatelic's acts may have potential beneficial impact for all lessees, or that Dell's distribution efforts may have a similar potential impact, are not indicators of horizontal commonality. The Sixth Circuit recognized that horizontal commonality is the proper test to be applied, but erred in its application to the facts of this case.

E. The Sixth Circuit erred in concluding that "profits" derived from the efforts of others has been demonstrated in this case where it is clear that plaintiffs' primary purpose in leasing the stamp masters was not profit, but rather, tax advantage and where the plaintiffs' own activities propelled any profit-making effort.

On rehearing, the panel spoke of plaintiffs' single investment motive ["attracted solely"] but still found it necessary to ascribe dual motives to the plaintiffs' decision to lease the stamp masters: tax advantage and "true" profits in the sense of a return on investment:

> The investors in the present cases, as we must assume at this point, likewise had no desire to take personal possession of the stamp masters or use the masters themselves; unlike the plaintiffs in *Deckebach* [867 F.2d

> 278 (6th Cir., 1989)], *the plaintiffs here were attracted solely by the prospect of tax savings and a return on their investments*. [emphasis supplied]

Referring to Philatelic's offering memorandum and what the court characterized as its "glowing account of the popularity of stamp collecting", the panel writing in this case was not prepared to "rule out the possibility that Philatelic's investors hoped to realize 'profits' in the true sense of the term", 888 F.2d 395. As is clear from the Sixth Circuit's opinion, any claim to "true" profit motivation could not be maintained if plaintiffs were required to demonstrate that "true" profits, and not tax advantage, was their primary motive.

As the Magistrate aptly wrote in this case: "Plaintiffs all but concede that there was no reasonable expectation of profits (at least from the efforts of others) from the sale or marketing of their stamps °°°" (Magistrate's Opinion, p. 12). This was the only conclusion to be drawn, given the zeal with which plaintiffs advanced the view that their expected "profits," sufficient to confer security status, were the hoped-for tax benefits.

There can be no factual dispute but that profits were not the *primary* motive for these plaintiffs' investments. In briefing these cases in the Sixth Circuit plaintiffs reported they were adversely affected by the government's successful challenge to the Philatelic shelter: " . . . [B]ecause[plaintiffs] had invested in the Stamp Masters *primarily* as a tax shelter and secondarily as a way of making profits through the marketing of stamps by professionals" (Plaintiffs' Brief on Appeal to Sixth Circuit, p. 19). Recognizing that tax advantage was plaintiffs' primary motive, the Sixth Circuit should have felt compelled to reject the claim that these leases constituted securities. Profit as a primary motive is required if plaintiffs are to be able to demonstrate a reasonable expectation of profit.

Profit as the primary motive is the measure of reasonableness required by this court's prior rulings in securities cases.

See *Howey, supra*, at 328 U.S. 300; 66 S. Ct. 1103 where such status was allowed given that plaintiffs were "attracted solely by the prospects of a return on their investment"; *Forman, supra*, at 421 U.S. 852 relying on the *Howey* plaintiffs' sole profit motive and narrowly describing the two categories of profit sufficient to supply a reasonable expectation and assure that such claims will not be speculative or insubstantial; *Daniels, supra*, at 439 U.S. 560; 99 S. Ct. 797, looking to the economic realities of the pension fund and concluding that the employee's selling his labor "primarily to obtain a livelihood, not make [ ] an investment" disqualified the transaction from achieving security status.

In accord in requiring that profit motive be primary over other motives: *Joyce* v *Ritchie Tower Properties*, 417 F. Supp. 53 (N.D. Ill., 1976) [Sale of condominium property to be occupied by plaintiff as his residence does not constitute sale of a security as, "an expectation of 'profit' is not the motive when one's home is involved. . ." (55)]; *Sunshine Kitchens* v *Alanthus*, 403 F. Supp 719 (S.D. Fla., 1975) [Rejecting claimed *Forman*-type profits, where plaintiff's motive was the hope of favorable tax benefits and where such hope turned on showing a loss, not a profit]; *Braniff Airways* v *LTV Corp.*, 479 F. Supp. 1279, 1286 (N.D. Texas, 1979) [In dicta, given that the tax benefit "is significant and central to the plan" for investment, there is "significant doubt" about whether the *Howey* test can be met].

Requiring that an investor's profit motive be primary before a reasonable expectation of profits can exist sufficient to support security status is a result which is also directed by relevant tax law considerations. In *Malet* v *Riddell*, 383 U.S. 569; 86 S. Ct. 1030 (1966), the Supreme Court rejected the petitioner's claim to capital gain treatment for profits derived from the sale of real property. The statutory imperative that the property have been held "primarily for sale to customers in the ordinary course of [the taxpayer's] trade or business", 26 U.S.C. §1221(1), was interpreted to require such motive as "of first motivation" or "principally".

Correspondingly, in a tax case arising out of defendant Finesod's "Jackie Fine Arts" art masters tax shelter, the taxpayer's admission " . . . that tax considerations played a substantial role . . . " in the decision to purchase the art masters, disallowed the claim to any investment tax credits, *Rose* v *Commissioner*, 89-1 U.S.T.C., ¶9191. The Sixth Circuit panel in *Rose*, *Id.* approved the Tax Court's determination that the ITC must be disallowed since the acquisition of the art master was " . . . motivated primarily, if not exclusively, by tax considerations" and the taxpayers did not have "an actual and honest profit objective". In accord as to the "Jackie Fine Arts" leases, see *Ballard* v *Commissioner*, 56 T.C.M., 1988-426 . . . Dec.45, 060(M) [taxpayer denied interest and depreciation deductions, and ITC, as dealings between taxpayer and promoter indicated taxpayer was primarily motivated by the tax benefits to be gained rather than by profit].

The Sixth Circuit should not have been satisfied by the tenuous and hypothetical profit motive that it ascribed to the plaintiffs in this case. Acquiring profits by marketing the stamps was, at best, a very minimal motivator. Clearly, the primary motive for plaintiffs was tax avoidance. Given plaintiffs' meager marketing efforts, the possibility of marketing the stamps successfully was "far too speculative and insubstantial to bring the entire transaction within the Securities Acts", *Forman, supra*, at 421 U.S. 856; 95 S. Ct. 2062; *Daniels, supra*, at 439 U.S. 562; 99 S. Ct. 798. The Sixth Circuit erred by being satisfied with speculation about stamp sales "taking off". Plaintiffs' primary investment motive was tax avoidance/tax advantage and this is not sufficient to support identifying a transaction as a security.

The Sixth Circuit concluded " . . . that there cannot be an investment contract without some hope of profits *produced by the efforts of others* . . . ", 888 F.2d 395 (emphasis added), but then seemed to lose sight of the fact that it was the plaintiffs' own activities which propelled any profit-making

effort. This was made very clear by the Confidential Information Memorandum requiring that each plaintiff handle his own exploitation, distribution, and sale of stamps and ancillary products.

Simply because the lessees apparently delegated their authority to Dell, does not relieve them of the duties imposed upon them by the various closing documents, *Nakagawa, supra*, at 95,134 [a Philatelic case], citing *Schultz* v. *Dain Corporation*, 568 F.2d 612, 615 (8th Cir., 1978). The same conclusion was reached in *Lakshmikanth* v. *Philatelic, supra* ["It is apparent based on documents before the Court that in order for the plaintiff to derive profits from his investment in the Stamp Master Program he was required to perform numerous and substantial duties"]; *Wells, supra* [as to art masters program: "If any income was to be realized from plaintiff's sale of reproduction of his art masters, such profits would clearly depend on his own efforts"]; in accord, *Kolibash, supra* [as to record masters program].

Plaintiffs' individual efforts were crucial if the stamp master program was actually to produce profits. The Sixth Circuit erred in being satisfied that the facts put before them by Plaintiffs demonstrated profits derived from the entrepreneurial or managerial efforts *of others*. The efforts were plaintiffs' own.

ADDENDUM

On February 21, 1990, this court released its Opinion in *Reves* v. *Ernst & Young*, ___ S. Ct. ___; 1990 W.L. 14015 (U.S.). The case analyzes whether uncollateralized promissory notes issued by a Farmer's Cooperative in order to raise money to support its general business operations and payable on demand by the holder constituted securities under the Securities Exchange Act of 1934. The majority concluded that the "note" category of instruments described as securities at §3(a)(1) of the Act applied to the transaction.

The *Howey* test for "investment contract" securities was not before the court and was viewed as "irrelevant to the issue," *Reves*, n.4. However, *Reves* offers general guidance for determining whether or not a transaction is a security. A four-part test is articulated:

> First, we examine the transaction to assess the motivation that would permit a reasonable seller and buyer to enter into it. If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments *and the buyer is interested primarily in the profit the note is expected to generate*, the instrument is likely to be a "security". . . [Emphasis added]

On the other hand, if exchanged to facilitate some other "commercial or consumer purpose", the instrument is less sensibly described as a security," *Id.* Thus, this court accepted that profit as a *primary* motive is crucial to the definition of a security. Significantly, at n.4, this court also reiterated the *Howey* definition of profit applicable to investment contracts, restricting profits to capital appreciation or participation in earnings.

Secondly, the "plan of distribution" is to be examined to determine whether there is "common trading for speculation or investment", *Reves*. As is clear from the offering materials, the stamp masters were being marketed and distributed primarily as a tax shelter, requiring the investor's own entrepreneurial effort if any profit was to be realized from sales.

Thirdly, the "reasonable expectations of the investing public" are critical, *Id.* The plaintiffs have been rather forthright in stating their expectations: they invested in the shelter primarily for its tax benefits and only secondarily for what marketing success might result. The investing public, reading the offering literature, would clearly have similarly understood that tax advantage was fueling the program.

Finally, the existence of another regulatory scheme which renders securities regulation unnecessary suggests that a

transaction is not a security, *Reves*. In this case, the United States prosecuted the principals involved with Philatelic. The operation was shut down pursuant to a regulatory effort under the Tax Equity and Fiscal Responsibility Act, 26 U.S.C. 6700 *et seq.*

As Justice Stevens wrote in concurrence in *Reves*, "there is a strong interest in enabling" those affected by securities issues to predict the legal consequences of their proposed actions. Defendant asks that this court continue the effort to create predictability on this crucial topic and to accomplish for the "investment contract" security category what *Reves* accomplishes for the "note" category.

CONCLUSION

The nature of the common enterprise required to support the existence of a security is an issue which has divided the Courts of Appeals for more than a decade. Even where the lower courts purportedly adopt identical interpretations of this Court's decisions, in application, and as this case demonstrates, the results are unpredictable. This is not tolerable, particularly in times like the present when securities regulation performs crucial public policy functions. Further, the Sixth Circuit's analysis of the required profit motive conflicts with prior decisions of this Court. The Writ of Certoriari should be granted.

Respectfully submitted,
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Dated: February 21, 1990

Supreme Court, U.S.
FILED
FEB 26 1990
JOSEPH F. SPANIOL, JR.
CLERK

89-1455

In The Supreme Court of the United States

October Term, 1989

TRAGER, GLASS & COMPANY,
Petitioner,

vs.

JOSEPH M. NEWMYER, JOHN W. KWIATKOWSKI,
JOHN C. COLLINS and TOBIN R. COLLINS,
Respondents,

TRAGER, GLASS & COMPANY,
Petitioner,

vs.

EDWARD O'CONNELL,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

APPENDIX TO PETITION FOR WRIT OF CERTIORARI

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15 U.S.C. §77(b)(1)

77b. Definitions.

When used in this subchapter, unless the context otherwise requires —

(1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. §78c(a)(10)

78c. Definitions and application.

(a) Definitions.

When used in this chapter, unless the context otherwise requires —

(10) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

RECOMMENDED FOR FULL TEXT PUBLICATION
See Sixth Circuit Rule 24

Nos. 88-1345/89-1288

UNITED STATES COURT OF APPEALS

FOR THE SIXTH CIRCUIT

JOSEPH M. NEWMYER, JOHN W. KWIATKOWSKI, JOHN C. COLLINS and TOBIN R. COLLINS, (88-1345)
Plaintiffs-Appellants,

v.

PHILATELIC LEASING, LTD., *et al.*,
Defendants-Appellees.

EDWARD O'CONNELL, (89-1288)
Plaintiff-Appellant,

v.

PHILATELIC LEASING, LTD., *et al.*,
Defendants-Appellees.

ON APPEAL from United States District Court for the Eastern District of Michigan

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Decided and Filed October 20, 1989

Before: MERRITT, Chief Judge, NELSON, Circuit Judge, and CELEBREZZE, Senior Circuit Judge.

DAVID A. NELSON, Circuit Judge. As a speculative investment, presumably, and as a device for sheltering income from taxes, the plaintiffs in these consolidated cases

executed standard-form lease and security agreements under which, in exchange for cash and promissory notes, they acquired leasehold interests in plates for printing local postage stamps bearing the names of certain small islands off the coast of Scotland. The plaintiffs had no knowledge of or experience in the stamp business, and each plaintiff elected to have the lessor, defendant Philatelic Leasing, Ltd., arrange for the printing of the stamps. In addition, most of the plaintiffs contracted with defendant Dell Philatelic Consultants, Ltd. to sell the stamps to collectors for a commission of 25 percent. The plaintiffs agreed that 50 percent of the remaining proceeds would be paid to Philatelic Leasing, in the form of prepayments on the notes, until the notes were paid in full.

The Internal Revenue Service disallowed the deductions and credits claimed by the plaintiffs on their individual tax returns. Alleging fraud and conspiracy to defraud, the plaintifs then sued the promoters of the tax shelter, with their lawyers, accountants, and others, under the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk, the Securities Act of 1933, 15 U.S.C. §§ 77a-77bbbb, and the Racketeer Influenced and Corrupt Organizations Act ("RICO"), 18 U.S.C. §§ 1961-68.

The lawsuits were dismissed by the district court on motions filed under Rule 12(b)(1) and (6), Fed. R. Civ. P. The court held among other things, (a) that the agreements at issue did not represent "securities," not being "investment contracts" within the meaning of the federal securities laws, and (b) that the plaintiff could not show the requisite "pattern of racketeering activity," within the meaning of RICO, because the predicate acts were all part of a single scheme.

The "single scheme" test has now been rejected by the Supreme Court, see *H.J. Inc. v. Northwestern Bell Telephone Co.*, _ U.S. _, 109 S.Ct. 2893 (1989), and we shall reverse the dismissal of the plaintiffs' RICO claim for that reason.

Whether the plaintiffs could show that their investments qualified as securities is a closer question, but we are not prepared to say at this juncture that the plaintiffs were not investing in "securities." We think this question presents genuine issues of material fact, and the dismissal of the claims asserted under the securities laws will therefore be reversed as well.

I

The island of Staffa, an uninhabited outcropping of rock measuring about 3/4 mile long and 1/3 mile wide, is located near the Isle of Ulva in the Inner Hebrides. Johnson and Boswell visited the proprietor of Ulva and Staffa, the Chief of the Clan M'Quarrie, during their tour of the Hebrides in 1773, and the travelers were distressed to hear that although the property had been in Mr. M'Quarrie's family for 900 years, it was soon to be sold for the payment of his debts. One wonders what thoughts would have gone through the minds of the impecunious M'Quarrie and his distinguished visitors if they could somehow have foreseen the multimillion dollar financial maneuvers with which the name of Staffa was to be associated in the 20th Century.[1]

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[1]Outside the tax shelter industry, the island's chief claim to fame, according to defendant Philatelic's promotional literature, is its numerous caves. One of these grottos—"the legendary Fingal's Cave"—is said to have inspired Mendelsohn's *Hebrides* Overture. (Professor Jonathan Kramer tells us, however, that the opening theme of the overture was in fact written before Mendelsohn visited Staffa.)

The caves of Staffa have long attracted tourists, but Dr. Johnson found little interest in them among the nearby islanders. The indifference of the locals to these natural curiosities prompted the bemused Englishman to commit the following reflections to paper:

> "When the islanders were reproached with their ignorance, or insensibility of the wonders of Staffa, they had not much to reply. They had indeed considered it little, because they

Sometime before 1979, as we learn from *United States v. Philatelic Leasing, Ltd.*, 601 F.Supp. 1554 (S.D.N.Y.), *aff'd*, 794 F.2d 781 (2d Cir. 1986),[2] the British government granted the Laird of Staffa and several other Scottish islands a right to issue postage stamps. The stamps would be good only for the carriage of mail between points on the islands or to the nearest British post office, where regular British postage would have to be affixed if the mail were to travel further.

The complaints in the present lawsuits, the factual allegations of which have been largely accepted as true for purposes of the motions to dismiss, state that beginning in 1979 a British corporation called Crailheath, Ltd. started acquiring stamp production rights from the islands' owners. Crailheath was owned by a certain Clive Feigenbaum. The plaintiffs' briefs assert that Mr. Feigenbaum also owned defendant Dell Philatelic Consultants, Ltd., a Massachusetts corporation with which all but one of the plaintiffs ultimately contracted to market their stamps.[3]

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had always seen it; and none but philosophers, nor they always, are struck with wonder, otherwise than by novelty. How would it surprise an unenlightened ploughman, to hear a company of sober men, inquiring by what power the hand tosses a stone, or why the stone, when it is tossed, falls to the ground!" Samuel Johnson, *A Journey to the Western Islands of Scotland* (1st ed. 1775).

[2]These informative opinions, the first by District Judge Knapp and the second by Circuit Judge Oakes, were issued in a lawsuit brought by the United States in an effort—a successful effort, as it turned out—to close down Philatelic Leasing's tax shelter operations under the Tax Equity and Fiscal Responsibility Act of 1982.

[3]An affidavit by the president of defendant Philatelic Leasing says that Philatelic, at least, was not affiliated with Dell in any way and that Philatelic and Dell had no common officers, directors, employees, or shareholders. The plaintiffs, on the other hand, allege that all of the defendants were participants in a common conspiracy and that they were acting in concert.

The consideration given by Crailheath for the stamp production rights was quite modest: $3.60 for each separate type of stamp produced, plus some free stamps. In subsequent transfers, as we shall see, the amount of money involved grew considerably larger.

Crailheath assigned its stamp production rights to defendant Global International, a Liberian corporation said to be controlled by Feigenbaum. See *Philatelic Leasing*, 794 F.2d at 783. Global had sets of stamp-printing plates—called "masters"—manufactured for it at a cost of approximately $1,000 per master.

On May 31, 1982, pursuant to what the plaintiffs allege was a fraudulent scheme to over-value the stamp masters, Hambrose Stamps, Ltd., a New York corporation controlled by defendant Herman Finesod, signed an option contract for the purchase from Global of up to 9,711 stamp masters, with associated copyrights, at prices ranging from $106,800 for a master that would produce two different stamps to $207,500 for a master that would produce eight different stamps. Less than two percent of these prices would be payable in cash; the balance was to take the form of promissory notes issued without recourse against Hambrose.

One day later, on June 1, 1982, Hambrose entered into an option and security agreement with defendant Philatelic, a thinly capitalized New York corporation owned by defendant Melvin Hersch. (Hersch had been hired by Finesod to act as president of Hambrose in 1980 and 1981, a period when Hambrose was making direct sales of stamp masters to the public; there was a shift from sales to leases in 1982, at which time Hersch moved from the presidency of Hambrose—where he was replaced by Finesod—to the presidency of Philatelic. See *Philatelic Leasing*, 794 F.2d at 784.)

Under the June 1 agreement, a two-stamp master that ostensibly cost Hambrose $106,800 could be acquired by Philatelic at a cost of $150,000. An eight-stamp master that

ostensibly cost Global $207,500 would cost Philatelic $400,000. By the end of 1982, Philatelic had purchased 830 masters at prices in this range.

Philatelic had no substantial assets, and its purchases of stamp masters were made largely on credit. Philatelic gave Hambrose promissory notes with maturities and interest rates comparable to those in the notes Hambrose gave Global. The notes were issued with recourse against Philatelic, for whatever that might be worth, and they were guaranteed by Mr. Hersch personally.

Mr. Hersch had a net worth of approximately $200,000, according to the complaints; the principal amount of the Philatelic notes exceeded $160 million. The extent to which Hambrose would actually receive payment on the Philatelic notes depended almost entirely, therefore, on how much Philatelic could collect from those to whom it sold leases.

Whether Philatelic could make good on the notes given in payment for the masters would seem to have a significant bearing on whether the prices Philatelic had agreed to pay could be said to bear any relation to the masters' actual value. And the value of the masters was of critical importance to the tax advantages that Philatelic's customers hoped to achieve.

Tax savings may not have been the sole inducement for prospective investors to sign up with Philatelic—and it is significant, perhaps, that none of the plaintiffs here was in the highest tax bracket—but Philatelic and its sales force stressed the tax advantages of the investments strongly, and the tax laws in effect in 1982 unquestionably made many investors more receptive to tax shelter investments than they would have been if income taxes had been lower. Under the 1982 tax rate schedule for a single taxpayer, a person who had a taxable income of $41,500 per annum would be required to pay federal income taxes of $12,068, not counting Social Security taxes. For each dollar of income in excess of

$41,500, the taxpayer would have to turn 50 cents over to the federal government. Many people in this tax bracket were eager to retain more than half of their marginal income, and sales of tax shelters flourished.

The design of the shelter offered by Philatelic may be explained by reference to plaintiff John Kwiatowski's case, which appears typical. In November of 1982 Mr. Kwiatowski entered into a lease and security agreement under which Philatelic contracted to give him a seven-year lease in a designated master and the right to print 60,000 sheets of two local stamps of the Island of Staffa. The stated rental was $30,000 per annum. Mr. Kwiatowski made a down payment of $4,500 in cash on the signing of the agreement. An additional $10,500, covered by a negotiable promissory note bearing interest at 10 percent, was to be paid on June 1, 1983, and all of the remaining lease payments were covered by non-negotiable notes due on February 1, 1990. Mr. Kwiatowski was not personally liable for payment of the major part of the principal and interest on the notes, but he had to execute an assignment to Philatelic of 50 percent of the net receipts from all sales of the stamps. Such net receipts were to be accounted for and paid over semi-annually, and the distribution company that was engaged to market the stamps was irrevocably authorized to pay Philatelic 50 percent of all amounts to which Mr. Kwiatowski might become entitled. The lease reflects a payment to Philatelic of $2,000 to cover the cost of having the stamps printed. Mr. Kwiatowski also entered into a distribution agreement with defendant Dell Philatelic Consultants, Ltd., contracting to pay Dell $500 upon the signing of the agreement, $1,450 two months later, $250 from initial stamp sales, and 25% of all receipts from subsequent sales.

The lease agreement recited that the stamp master had cost Philatelic $150,000. Philatelic agreed to make an election "to pass through the investment tax credit relative to the Master to the Lessee. . . ." The investment tax credit would be 10

percent of Philatelic's cost, as we understand it, if that cost represented the property's fair market value on the date possession was transferred to the lessee — so Mr. Kwiatowski could expect to receive a direct credit against his personal income tax liability in the amount of $15,000 if the master was worth what Philatelic purported to have paid for it.

In addition to the investment tax credit, the taxpayer expected to obtain a tax deduction for his lease payments, including the portion of the notes qualifying as deductible under the "at risk" rules and, we assume, the net receipts that had to be paid over to Philatelic in satisfaction of the nonrecourse notes. Finally, fees paid for having the stamps printed and marketed were also expected to be deductible, although Philatelic's promotional literature pointed out that "production costs are not deductible when incurred but must be assigned to products produced and deducted upon their sale."

Philatelic marketed the tax shelter, according to the Second Circuit opinion, through a nationwide force of three to four hundred commissioned salespersons. *Philatelic Leasing*, 794 F.2d at 783-84. Defendant Robert V. Yeo, Jr., a certified public accountant, is claimed to have been such a commissioned salesperson, although Plaintiff John C. Collins swore in an affidavit that Yeo told him he received no commissions from Philatelic. Be that as it may, it is apparently undisputed that while acting as an accountant and tax adivsor for the plaintiffs, Mr. Yeo enthusiastically recommended Philatelic's tax shelter to them. According to the Collins affidavit, Mr. Yeo said it "was the best tax shelter he had ever seen and [he] had even invested in it himself." Mr. Yeo allegedly told Plaintiffs Collins, Newmyer, and O'Connell that the Philatelic program had a four-dollar tax write-off for each dollar invested. An "illustration of tax consequences" set forth in Philatelic's literature suggests that an investor in the 50 percent tax bracket could get tax credits and deductions equivalent to

a write-off of approximately four times the investor's 1982-83 cash outlay.

Several of the plaintiffs were invited to a Philatelic sales presentation attended, according to one affidavit, by about 25 of Mr. Yeo's clients. At this meeting, which was held at the Detroit Athletic Club in November of 1982, the promoters allegedly described the market for the stamps as "strong." Each of the plaintiffs received an "offering memorandum" describing the program in detail and incorporating, among other things, a tax opinion letter prepared by defendant Friedman and Shaftan, P. C., a New York law firm. The offering memorandum also included letters in which the law firm and defendant Trager, Glass & Company, a New York firm of certified public accountants, confirmed that they had agreed to represent Philatelic in connection with any challenge by the Internal Revenue Service to the tax structure of the transaction set forth in the memorandum.

With respect to the key question of the value of the stamp masters in Philatelic's hands, the tax opinion incorporated in the offering memorandum had this to say:

> "In each case Hambrose will deliver to Philatelic reports from two stamp dealers, acting as appraisers of the Stamp Master, who are knowledgeable in the local stamp industry as to the value of the Stamp Master. . . . These Appraisals will then by furnished by Philatelic to each Lessee. The Appraisals, taken together, indicate that the estimated fair market value of the Stamp Master is at least equal to the Purchase Price paid by Philatelic. The Appraisals suggest that, while an investment in a Stamp Master is highly speculative, there is a reasonable likelihood that the sales from exploitation of the Stamp Master will be sufficient to repay the Notes (and repay the Obligations) and to generate profits to Philatelic and Lessees."

Under the caption "Printing of Stamps," the offering memorandum explained, among other things, that

> "Philatelic, as agent for the Lessee, will arrange for a maximum of two printings of stamps (if the Lessee so desires). The production fee is $2,000 for a two-stamp or four-stamp master, $2,500 for a six-stamp master and $3,000 for [an] eight-stamp master."

None of the plaintiffs had any prior experience in the stamp business, and each plaintiff elected to have Philatelic arrange for printing.

Under the caption "Distribution," the offering memorandum explained how stamp distributors typically operate and noted that although some lessees might elect to handle the task of distribution on their own, "the vast majority of Lessees are likely to select an established distribution company." A number of distribution companies were said to be "readily available." The memorandum added that "Philatelic cannot be a party to negotiations with these distributors."[4]

Under the guidance of Defendant Yeo, who had allegedly followed this course himself, Plaintiffs Newmyer, Kwiatowski, and Collins all signed preprinted distribution agreements engaging defendant Dell Philatelic Consultants, Ltd. as "the exclusive marketing agent of Lessee for the Stamps." Dell agreed to use "reasonable efforts" to sell the stamps, but there was to be no "minimum sales guarantee or obligation." (Plaintiff O'Connell also intended to market the stamps through a professional stamp company, according to his affi-

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[4]A somewhat similar disclaimer may be found in the offering memorandum involved in *SEC v. Aqua-Sonic Products Corp.*, 524 F.Supp. 866, 870 (S.D.N.Y. 1981), *aff'd*, 687 F.2d 577 (2d Cir.), *cert. denied sub nom. Hecht v. SEC*, 459 U.S. 1086 (1982). That memorandum said that the licensor "takes no position" on the matter of retaining sales agents—but, as we shall see, the scheme involved there was held to be an investment contract nonetheless.

davit, "but we never signed the papers because the federal government intervened in the tax shelter.")

On June 13, 1983, the United States filed its lawsuit against Philatelic, Hersch, Hambrose, and Global for "promoting abusive tax shelters" in violation of 26 U.S.C. § 6700.[5] A settlement was reached with Global, but the case against the other defendants went to trial and culminated in a judgment, entered in 1985, wherein the remaining three defendants were found to have made "gross valuation overstatements" in connection with the organization and sale of the Philatelic tax shelter.

District Judge Knapp found that "the masters themselves had no substantial value." 601 F. Supp. at 1567. The court of appeals, in affirming, said that it was hard to see how he could have found otherwise, in light of the evidence. 794 F.2d at 785. Whether the defendants were part of a conspiracy was not at issue in the government's case, notwithstanding some "unnecessary" observations by Judge Knapp on the nature of the relationship among the defendants, "but the legitimate meaning of his decision comes through loud and clear—the tax shelter sold by the appellants was a sham and the appellants knew it." *Id.* The judgment entered by Judge Knapp and affirmed by the Second Circuit enjoined Philatelic, Hambrose, and Hersch from continuing to offer the Philatelic tax shelter for sale and from otherwise engaging in conduct (such as organizing or selling interests in any other investment plan

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[5]Section 6700 authorizes the imposition of penalties against persons who organize or sell interests in any partnership or "any investment plan or arrangement" or any other plan or arrangement and in connection therewith make a false statement on tax benefits or make "a gross valuation overstatement as to any material matter." The term "gross valuation overstatement" is defined as a statement as to the value of property directly related to the amount of a tax deduction or credit, where the value stated exceeds 200 percent of the amount determined to be the correct valuation.

or partnership involving gross valuation overstatements) proscribed by the language of 26 U.S.C. § 6700.

In tax filings prepared, in part, by Defendant Yeo, the plaintiffs in the present cases claimed a variety of tax deductions and credits in connection with their investments, all of which deductions and credits were disallowed by the Internal Revenue Service. The IRS also asserted claims for penalties and interest. In their affidavits, plaintiffs put their total estimated liability to IRS at two or three times the amount of their total cash investments.

The plaintiffs filed virtually identical lawsuits against Philatelic *et al.* in the United States District Court for the Eastern District of Michigan, asserting claims under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j, and under RICO, among other things, along with pendent common law claims for fraud and deceit, civil conspiracy, negligence, malpractice, and breach of contract. The defendants asserted a variety of defenses, including, in some cases, lack of personal jurisdiction; the only defenses that concern us here, however, involve jurisdiction over the subject matter of the actions and, in the case of the RICO counts, a supposed failure to state a claim upon which relief can be granted. These defenses were raised by way of motions to dismiss filed under Rule 12, Fed. R. Civ. P.

The motions were referred to a magistrate. In a well-written report, the magistrate recommended dismissal of the federal securities fraud claims on the ground that the plaintiffs' lease and security agreements did not quailify as "securities." The magistrate recommended dismissal of the RICO claims on the theory—adopted by the Eighth Circuit in *Deviries v. Prudential Bache Securities, Inc.*, 805 F.2d 326 (8th Cir. 1986)—that RICO applies only where the predicate acts of misconduct occur in separate fraudulent schemes. And the magistrate recommended dismissal of the state law claims, without prejudice, pursuant to the general rule that pendent jurisdic-

tion should not normally be exercised after all federal claims had been dismissed prior to trial. *United Mine Workers of America v. Gibbs*, 383 U. S. 715 (1966). The district court adopted the magistrate's report and recommendation without elaboration, and the plaintiffs appealed. The appeals have been consolidated.

II

In its current form, the 1934 Securities Exchange Act's definition of a "security" covers, among other things,

> "... any note, stock, treasury stock, bond, debenture, certificate of deposit or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract...or in general, any instrument commonly known as a 'security'...."

The definition in the 1933 Securities Act, 15 U.S.C. § 77b(1), is similar, as the Supreme Court has noted. *Tcherepnin v. Knight*, 389 U.S. 332, 335-36 (1967).

Originally, neither statute listed oil and gas leases, *eo nomine*. In a 1943 decision written by Mr. Justice Jackson, however, the Supreme Court held that notwithstanding this omission, the Securities Act of 1933 covered resales of certain oil and gas leases that were marketed through a nationwide mail compaign. *SEC v. C. M. Joiner Leasing Corp.*, 320 U.S. 344 (1943). The advertising literature used in *Joiner* "emphasized the character of the purchase as an investment and as a participation in an enterprise," and the value of each lease was claimed to be enhanced by the vendor's commitment to drill an exploratory well so located as to test the oil-producing possibilities of the offered leaseholds. *Id.* at 346. This was enough to bring the offering within the purview of the 1933 Act, in the Court's view.

Although defendant Philatelic, the lessor in the present cases, did not itself undertake to do anything directly comparable to the drilling of the test well in *Joiner*, the *Joiner* decision does make it clear that the failure of Congress to mention "leases" in its laundry list of securities does not mean that all leases were necessarily excluded from the statutory definition. One of the appellants in the instant cases points out that a "cursory review" of the statutory definitions "indicates that they do not include the term 'stamp lease.'" That is true, but *Joiner* teaches that "[n]ovel, uncommon or irregular devices, whatever they appear to be, are also reached if it be proved as a matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as 'investment contracts,' or as 'any interest or instrument commonly known as a "security." ' " *Id.* at 351. Thus the "stamp leases" sold by Philatelic, novel though they undoubtedly were, could also be reached by the statute if they were widely offered under courses of dealing that establish their character as "investment contracts."

A novel device that may well have borne an affinity to the tax shelter at issue here was held to be an investment contract, and thus a security under the 1933 Act, in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). The Howey Company, which owned large tracts of citrus acreage in Florida, offered to sell narrow strips of land in its citrus groves to prospective investors in other states. Investors were promised a warranty deed to the land. They were also given the option — but were not required — to lease their strips of land to a service company controlled and managed by the same people who controlled and managed the Howey Company. Investors who selected this option could have the service company cultivate the land and harvest and market the crops under the service contract. About 85 percent of the acreage sold by Howey was covered by such service contracts.

The question presented in *Howey* was whether, under the facts as stipulated by the parties, the land sales contract, warranty deed, and service contract together constituted an "investment contract" under the 1933 Act. Concentrating on economic realities, and emphasizing substance over form, the Court answered this question in the affirmative.

The investors in *Howey*, the Court noted, were "predominantly business and professional people who lack[ed] the knowledge, skill and equipment necessary for the care and cultivation of citrus trees." 328 U.S. at 296. The plaintiffs in the case at bar, similarly, may be presumed to lack the knowledge and skill necessary for the marketing of stamps to collectors. The investors in *Howey* were "attracted by the expectation of substantial profits." *Id.* Although the plaintiffs in the case at bar were attracted in part by the expectation of substantial tax advantages, it is certainly open to them to try to prove they had a profit motive too. (As Philatelic's offering memorandum explained very clearly, indeed, if the stamp operation were not "engaged in for profit (aside from tax savings)," the tax advantage would not be available —and "[w]here the facts of the transaction indicate that no profits are possible or that such profits are unlikely, the activity will be considered to lack the requisite profit motive, particularly if the transaction has substantial tax avoidance motivations.")

In substance, if not in form, the individual investors in *Howey* "were led to invest money in a common enterprise with the expectation that they would earn a profit solely through the efforts of the promoter or of someone other than themselves." *Id.* at 298. The *Howey* scheme thus fit the "investment contract" definition applied by the state courts in a variety of situtations under state blue sky laws—which, as the Court observed, was the definition underlying the decision in *Joiner*. 328 U.S. at 298-99. That definition, the *Howey* court went on to say, "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the count-

less and variable schemes devised by those who seek the use of the money of others on the promise of profits." *Id.* at 299. And the definition was flexible enough to cover the *Howey* offering notwithstanding that the investors in 15 percent of the acreage declined to enter into optional service contracts with the *Howey* company's affiliate: "It is enough that the respondents merely *offer* the essential ingredients of an investment contract." *Id.* at 301 (emphasis supplied).

In the case at bar, the plaintiffs have alleged that the defendants Yeo, Philatelic and Dell were all participants in a common conspiracy. Philatelic and Dell were not under common ownership and did not have common directors and officers, but that would not of itself preclude a finding that the two companies were acting in concert. If they were, and if Mr. Yeo was acting on their behalf, the distribution contract recommended by Mr. Yeo would seem to be the functional equivalent of the service contract offered by the service company affiliate in *Howey*.[6] The plaintiffs in the instant cases

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[6]We pause here to note some of the possible parallels between the instant scheme and that involved in *SEC v. Aqua-Sonic Products Corp.*, 687 F.2d 577 (2d Cir. 1982), cited in n.4, *supra*. In that case—which, like the instant litigation, saw Melvin Hersch named as defendant—purchasers of a tax shelter involving licenses for the manufacture and distribution of dental devices were offered an optional sales agency agreement with a corporation called Ultrasonic. The licensor was a corporation called Aqua-Sonic. The corporations were wholly owned by their respective principal officers—each of whom was the sole shareholder of his corporation, see 524 F.Supp. at 868—but the men were undoubtedly acting in concert. Licenses were sold through CPAs and the like to investors with no prior experience in selling dental products. If a licensee elected to sign a sales agency agreement with Ultrasonic, that company would undertake to perform functions comparable to those assigned to the service company in *Howey* and to defendant Dell in the present litigation. Notwithstanding that the sales agency agreement was optional—and the promoters' offering memorandum "did not mention an offer by anyone to act as a sales agent," see 524 F.Supp. at 870—the Second Circuit, speaking through Judge Friendly, found

were no more equipped to distribute stamps produced from the plates leased from Philatelic than the *Howey* investors were equipped to distribute oranges grown on the land purchased from the *Howey* company. In both situations, as a practical matter, the investors had to rely on the efforts of others to do the necessary selling. And if the plaintiffs in the present litigation are able to prove their cases, the commitment given by the distribution company here, like that given by the service company in *Howey*, would bear a strong resemblance to the undertaking to drill an exploratory oil well in *Joiner*.

No comparable commitment to activity calculated to help investors realize a profit could be found in *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975), a decision in which the Supreme Court emphatically reaffirmed *Howey* and *Joiner*. The question in *Forman* was whether the statutory definition of securities covered shares that entitled a purchaser to lease an apartment in a subsidized non-profit housing cooperative. As far as the "investment contract" aspect of this question was concerned, the Court declared, it was necessary to "examine the substance—the economic realities of the transaction—rather than the names that may have been employed by the parties." 421 U.S. at 851-52. Quoting

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no error in the district court's conclusion that the investors expected to derive profits from the efforts of others and thus had entered into "investment contracts." Contracts were being offered to precisely the type of investor for whose benefit the securities laws were enacted, the Second Circuit noted, and while the totality of the circumstances must always be considered in determining where a particular scheme falls in relation to the line that divides "investment contracts" from contracts not covered by the broad definition of a security, "we have not the slightest doubt on which side of the line this case falls." 687 F.2d at 585. "[I]n light of the economic realities of this case and the precedents in the Supreme Court, in the state courts prior to adoption of the 1933 Act, and in the courts of appeals thereafter, the Aqua-Sonic scheme was an 'investment contract' and therefore a 'security.' " *Id.*

Howey, 328 U.S. at 301, the Court said that the "basic test" for distinguishing an investment contract from other commercial dealings is "whether the scheme involved an investment of money in a common enterprise with profits to come solely from the efforts of others." 421 U.S. at 852.

The *Forman* court, speaking through Justice Powell, continued as follows:

> "This test, in shorthand form, embodies the essential attributes that run through all of the Court's decisions defining a security. The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others. By profits, the Court has meant either capital appreciation resulting from the development of the initial investment, as in *Joiner*. . . or a participation in earnings resulting from the use of investors' funds, as in *Tcherepnin v. Knight*, [389 U.S. 332]. . . . By contrast, when a purchaser is motivated by a desire to use or consume the item purchased—'to occupy the land or to develop it themselves,' as the Howey court put it, *ibid.*—the securities laws do not apply." *Id.* at 852-53 (footnotes omitted).

In *Forman* there could be "no doubt that investors were attracted solely by the prospect of acquiring a place to live, and not financial returns on their investments." *Id.* at 853. If the plaintiffs in the instant cases had leased stamp masters solely for the purpose of producing stamps for their own pleasure, without any thought of capital appreciation or earnings from stamp sales, *Forman* makes it clear that the securities laws could have no application here. But the fact that most of the plaintiffs engaged defendant Dell to sell their stamps for them suggest rather strongly, we think, that the plaintiffs were not motivated by a quixotic desire to paste hundreds of thousands of identical stamps in their albums.

Randall v. Loftsgaarden, 478 U.S. 647 (1986), the final Supreme Court decision that we shall discuss on the securities question, involved a defrauded tax shelter investor who was questionably entitled to some measure of relief under the securities laws. The issue addressed by the Supreme Court was whether the tax benefits realized by the investor should be offset against his recovery of recisionary damages under 15 U.S.C. § 77(1)(2), a section of the 1933 Act allowing a defrauded investor to recover what he paid for the security, with interest, "less the amount of any income received thereon. . . ."

Ruling in favor of the defrauded investor, the Supreme Court held that the money that the taxpayer had been enabled to keep out of the hands of the tax collector--money earned by the taxpayer through his own labor or as a return on other investments, rather than as a return on the investment in the tax shelter—did not constitute "income" received on the tax shelter investment. "[T]he 'receipt' of tax deductions or credits is not itself a taxable event," said Justice O'Connor, speaking for the Court, "for the investor has received no money or other 'income' within the meaning of the Internal Revenue Code." 478 U.S. at 657. Justice O'Connor found additional support for this conclusion in *Forman*, where the Court had rejected a claim that the deductibility of the mortgage interest component in the monthly rental paid by the apartment dweller converted his purchase of the right to lease the apartment into an "investment contract" potentially capable of producing income or profits. *Loftgaarten*, 478 U.S. at 657, citing *Forman*, 421 U.S. at 854-55.

The defendants in the present litigation cite *Forman* and *Loftgaarten* in arguing that there was no "investment contract" here because there was no reasonable expectation of profits to be derived from the efforts of others. We agree that there cannot be an investment contract without some hope of profits produced by the efforts of others, and we agree also that tax benefits alone cannot satisfy the profit require-

ment. Having read Philatelic's offering memorandum, however, with its glowing account of the popularity of stamp collecting, we cannot rule out the possibility that Philatelic's investors hoped to realize "profits" in the true sense of the term. The presence or absence of a profit motive is a question of fact, of course—and in resolving that question, we are sure, the trier of fact will not be unmindful of the appraisals furnished by Philatelic to show that, in the words of Messrs. Friedman and Shaftan, "there is a reasonable likelihood that sales from the exploitation of the Stamp Masters will be sufficient to pay all the Notes and to generate profits to the Lessee." It is awkward, to say the least, for the defendants to maintain that a profit motive does exist when it comes to applying the Internal Revenue Code, but not when it comes to applying the securities laws. See *SEC v. Professional Associates,* 731 F.2d 349, 356 (6th Cir. 1984), where this point was made in connection with tax shelters involving joint ventures formed to exploit leased phonograph record masters.

Finally, we come to the vexed question of whether there is any prospect of the plaintiffs being able to show not only a "common venture," but a common venture in which the plaintiffs' funds were pooled with those of other investors. This circuit, following the lead of Judge Stevens (as he then was) in *Milnarik v. M-S Commodities, Inc.,* 457 F.2d 274 (7th Cir. 1972), has repeatedly said that proof of a vertical relationship between seller and buyer is not in itself enough to establish the existence of investment contracts; there must also be a horizontal relationship between or among investors, with the funds of two or more investors going into a common pool from which all may benefit. *Curran v. Merrill Lynch, Pierce, Fenner and Smith, Inc.,* 622 F.2d 216, 221-22 (6th Cir. 1980), *aff'd on other grounds,* 456 U.S. 353 (1982); *Union Planters National Bank of Memphis v. Commercial Credit Business Loans, Inc.,* 651 F.2d 1174, 1183 (6th Cir.), *cert. denied,* 454 U.S. 1124 (1981); *Hart v. Pulte Homes of Michigan Corp.,* 735 F.2d 1001, 1003-5 (6th Cir. 1984).

If the plaintiffs in the instant cases can show a common enterprise among defendants Yeo, Philatelic and Dell, it may well prove to be a relatively simple matter for the plaintiffs to satisfy the "horizontal commonality" test. It is undisputed that most of the plaintiffs paid Dell to distribute their stamps. We have no reason to suppose that the marketability of one plaintiff's stamps differed materially from the marketability of another's,[7] and it is entirely possible that if Dell had used the plaintiffs' money to advertise or otherwise promote these local stamps, developing a real market for them, all of the plaintiff investors would have benefited, just as all of the investors in *Howey* stood to benefit from the service company's successful marketing of their oranges. These are factual questions, again, and the defendants may ultimately prevail on them. But such questions are not to be resolved against the plaintiffs on motions to dismiss — at least not on the sort of record that is before us here.

If the plaintiffs ultimately fail to substantiate their claim that the defendants were acting in concert, they are likely to find it more difficult to establish the requisite horizontal commonality. We are not ready to hold at this point that such a showing would be impossible, however.

All of the plaintiffs paid money to Philatelic, of course, and Philatelic stood to receive far larger amounts, under the lease and security agreements, if the world happened to develop the same appetite for local postage stamps that it has shown, on occasion, for such unlikely collectables as pet rocks, op art, and anything remotely connected with the late Mr. Elvis Presley. The fortunes of Philatelic were directly linked to the success or failure that the stamps enjoyed in the retail marketplace. This consideration leads us to disagree, respectfully,

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[7]In 1982 alone, it may be recalled, Philatelic sold rights to produce local stamps with more than 1600 different designs; there is no reason to suppose that these stamps were not more or less fungible.

with the conclusion reached in *Nakagawa v. Ellis & Ellis*, Fed. Sec. L. Rep. (CCH) ¶ 93,028 (U.S.D.Ct., D. Hawaii 1986), where the same tax shelter with which we are concerned here was held not even to meet the "vertical commonality" test used in the Ninth Circuit's investment contract cases.

In *Nakagawa* the district court found that Philatelic "was to derive its profits from the initial leasing of the stamp masters," no evidence having been produced "to show that Philatelic participated in any profits from the printing, sale, or distribution of stamps printed from stamp masters." It seems to us that this finding overlooks paragraphs 5(a)(4) and 12 of the terms and conditions of the lease and security agreement, which make it clear that until such time as the non-recourse notes constituting the bulk of the consideration might be paid in full, Philatelic was entitled to future payments of 50 percent of whatever net receipts were realized on sales of the stamps. Philatelic and its creditors were in a position to benefit hugely if those sales really took off.

Whether there is also a horizontal dimension to the commonality inherent in the arrangements linking Philatelic and the investors depends, we believe, on whether Philatelic was committed to action that might benefit the investors as a group. There are several possibilities in this regard, the most significant of which would seem to be (1) that Philatelic was committed to paying the bulk of its receipts over to Hambros, and (2) that Philatelic was committed to paying for a defense of the tax structure if the government brought an attack such as that launched in the Southern District of New York in 1983.

Philatelic's commitment to pay Hambros might well have a bearing on the actual value of the masters. Although it is value at the time of delivery that is significant for tax purposes, the plaintiffs argue that by the time a court reached the stage of actually determining value, the masters would have a revenue-production history that could be relevant to

the valuation question. The value of stamp masters is a question of fact, as Philatelic's offering memorandum accurately observes, and had it developed that Hambros, which sold the masters to Philatelic, was actually receiving revenues at a rate that might enable it to collect the very high prices that Philatelic had contracted to pay, we presume it would have been harder for the government to show that those prices were a sham. (This assumes, of course, that there is not much difference between stamps of one design and stamps of another — that stamps depicting the caves of the Island of Staffa, for example, would be about as marketable as stamps depicting the flora or fauna of the Island of Bernera. See n.7 *supra*.)

A variant of this argument has been accepted by some district courts — see, *e.g.*, *Kolibash* v. *Sagittarius Recording Co.*, 626 F.Supp. 1173 (S.D. Ohio 1986), and *In re Energy Systems Equipment Leasing Securities Litigation*, 642 F. Supp. 718 (E.D.N.Y. 1986) — and it has been rejected by others. See, *e.g.*, *Wells v. Jackie Fine Arts, Inc.*, Case No. C-2-86-0374, U.S.D.Ct., S.D. Ohio, Sept. 25, 1987, where defendant Herman Finesod was among those sued. See also *Lakshmikanth v. Philatelic Leasing Ltd.*, No. 3-83-0710, M.D. Tenn., Oct. 12, 1983 (holding Philatelic's tax shelter not a "security" because profits were not "to be derived from the entrepreneurial or managerial efforts of others.") Like the contention that horizontal commonality can be shown through Philatelic's commitment to defend the tax structure in court, the argument depends on the conclusion that a pooling of interests in the hope of securing tax benefits will satisfy the commonality requirement even though it cannot, by itself, satisfy the expectation of profits requirement. Where the Supreme Court would come out on that question—assuming the Court agrees with us that horizontal commonality must be shown —we do not know. We need not come to grips with the issue here, however, given the clear possibility that at a trial of these cases, or in summary judgment proceedings, the plaintiffs may be able to show that their arrangements with Dell got them over the commonality hurdle.

III

We turn now to RICO. A section of that statute patterned on § 16 of the Clayton Act provides that "[a]ny person injured in his business or property by reason of a violation of [18 U.S.C. § 1962] may sue therefor in any appropriate United States District Court and shall recover threefold the damages he sustains and the cost of the suit. . . ." 18 U.S.C. § 1964(c).

The plaintiffs in the instant cases contend that they were injured in their business or property by reason of violations of three separate subsections of 18 U.S.C. § 1962. The first is § 1962(a), which provides, in pertinent part, as follows:

> "It shall be unlawful for any person who has received any income derived, directly or indirectly, from a pattern of racketeering activity. . . to sue or invest, directly or indirectly, any part of such income, or the proceeds of such income, in acquisition of any interest in, or the establishment or operation of, any enterprise which is engaged in, or the activities of which affect, interstate or foreign commerce."

The district court held as a matter of law that the plaintiffs could not have been injured in their business or property by any violation of § 1962(a) "because there is simply no way that Plaintiffs could have been damaged by what Defendants did with their money *after* receipt of the lease payments." (Emphasis in original.) This conclusion is erroneous, in our view, because it overlooks the possibility that the offering of the particular investment plan in which the plaintiffs put their money may have been financed with the proceeds of prior "racketeering activity." The plaintiffs' complaints alleged that the defendants had been acting in concert over a period of five years, defrauding hundreds of taxpayers in addition to the plaintiffs; that in furtherance of their fraudulent scheme, the defendants had used the mails and facilities for wire communications to transmit false and misleading information within a ten-year period; and that such acts of mail

fraud, wire fraud and securities fraud constituted a pattern of racketeering activity. If these allegations are true, and if the defendants used income derived from racketeering activity in 1980 and 1981 to establish and operate the alleged scam in which the plaintiffs put their money in 1982 and 1983, we do not see why it would be impossible for the plaintiffs to show that they had been injured by a violation of § 1962(a).[8]

The district court also held as a matter of law that there could be no "pattern of racketeering activity," within the meaning of that phrase as used in 18 U.S.C. § 1962(a), because the acts of mail fraud, wire fraud and securities fraud that were claimed to form the "pattern" all constituted part of a single scheme. In so holding, the district court adopted an interpretation of RICO endorsed by the Court of Appeals for the Eighth Circuit in cases such as *Superior Oil. v. Fulmer*, 785 F.2d 252 (1986), *Deviries v. Prudential-Bache Securities, Inc.*, 805 F.2d 326 (8th Cir. 1986), *Ornest v. Delaware North Cos.*, 818 F.2d 651 (8th Cir. 1987), and *H. J. Inc. v. Northwestern Bell Telephone Co.*, 829 F.2d 648 (8th Cir. 1987).

Judge John R. Gibson, concurring separately in the opinion last cited, expressed the view that "the multiple scheme requirement that we [the Eighth Circuit] have grafted onto the pattern element strays from the statutory language of RICO;" Judge Gibson urged that "the multiple scheme requirement should be examined by the court en banc." 829 F.2d at 651. It was not the Eighth Circuit that examined the multiple scheme requirement en banc, as matters developed, but the Supreme Court. In a decision handed down in June

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[8]The complaints' averments of mail fraud and wire fraud are not "stated with particularity," as required by Rule 9(b), Fed. R. Civ. P., but the district court noted that "given the otherwise detailed description of the scheme, it would appear Plaintiffs could supply the specifics. . . ." We agree, and we anticipate that the pleading defect will be cured by amendment following the remand.

of this year, subsequent to the district court's decision in the cases at bar, the Supreme Court reversed the Eighth Circuit's judgment in *Northwestern Bell* and flatly rejected the multiple scheme requirement. *H. J. Inc. v. Northwestern Bell Telephone Co.*, _ U.S. _, 109 S.Ct. 2893 (1989).[9]

The Supreme Court's decision in *Northwestern Bell* clearly requires that we reverse the judgment in the present litigation insofar as the district court held that to be capable of forming a "pattern of racketeering activity" under RICO, the predicate criminal acts must have been committed in more than one fraudulent scheme. The district court applied the "multiple scheme" requirement not only in connection with 18 U.S.C. § 1962(a), but also in connection with §§ 1962(c) and (d), the other two subsections on which the plaintiffs rely.[10] The plaintiffs must be given an opportunity to show, if they can, that they were injured by reason of violations of all three subsections.

Defendants Trager, Glass and Robert Yeo argue that the dismissal of the RICO claim must be affirmed because the complaints failed to allege the existence of an "enterprise" distinct from the defendant "persons" and distinct from the alleged pattern of racketeering activity. It is true that a RICO "enterprise" must be separate and different from the

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[9]The court also expressed disagreement with the suggestion in *United States v. Jennings*, 842 F.2d 159, 163 (6th Cir. 1988), that a pattern is established merely by proving two predicate acts. 109 S. Ct. at 2899.

[10]18 U.S.C. § 1962(b) reads as follows:

> "It shall be unlawful for any person through a pattern of racketeering activity or through collection of an unlawful debt to acquire or maintain, directly or indirectly, any interest in or control of any enterprise which is engaged in, or the activities of which affect, interstate or foreign commerce."

18 U.S.C. § 1962(d) reads as follows:

> "It shall be unlawful for any person to conspire to violate any of the provisions of subsections (a), (b), or (c) of this section."

"persons" participating in the enterprise. *Fleischhauer v. Feltner*, 879 F.2d 1290, 1297 (6th Cir. 1989). "Only 'persons' can be held liable for RICO violations; the 'enterprise' itself is not liable." *Id.* The complaints in the present cases allege that each of the defendants is a "person" within the meaning of 18 U.S.C. § 1962 and that Philatelic was an "enterprise" engaged in affecting interstate or foreign commerce.

The complaints may have been defective insofar as they identify Philatelic as both a "person" and an "enterprise." But this defect, if defect it be, is material only to the claim against Philatelic; it is immaterial to the claims against the other defendants. And insofar as the RICO claim against Philatelic is concerned, we see no reason why the supposed pleading defect would not be readily correctable by amendment.

IV

After oral argument, the defendant-appellees moved for leave to brief the constitutionality of RICO. Prompted by *dicta* in both the majority and concurring opinions in the Supreme Court's *Northwestern Bell Telephone* decision, the defendants wish to argue, for the first time, that this "sprawling, amoeba-like statute," as it has been called,[11] is void because of the vagueness of the "pattern" requirement.

As a rule, this court declines to entertain arguments not presented in the first instance to the district court. *Sigmon Fuel Co. v. TVA*, 754 F.2d 162, 164 (6th Cir. 1985). The Supreme Court has told us that "a federal appellate court is justified in resolving an issue not passed on below . . . where the proper resolution is beyond any doubt, or where 'injustice . . . might otherwise result.'" *Singleton v. Wulff*, 428 U.S. 106, 121 (1976) (citations and footnote omitted). The proper resolution of the question of RICO's constitutionality is not

[11]Stewart, "Scoping Out Statutes," ABA Journal, Sept. 1989, at 54.

beyond any doubt, and no injustice would result from allowing the issue to be addressed in the first instance by the district court in the context of a properly developed record.

The motion for leave to file a supplemental brief in **DENIED**. The judgment of the district court is **REVERSED**, and the case is **REMANDED** for further proceedings not inconsistent with this opinion.

NOS. 88-1345/89-1288

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

FILED
Nov. 27, 1989
LEONARD GREEN,
Clerk

JOSEPH M. NEWMYER, JOHN W. KWIATKOWSKI, JOHN C. COLLINS and TOBIN R. COLLINS, (88-1345),

Plaintiffs-Appellants,

v.

PHILATELIC LEASING, LTD., et al.,

Defendants-Appellees,

EDWARD O'CONNELL, (89-1288)

Plaintiff-Appellant,

v.

PHILATELIC LEASING, LTD., et al.,

Defendants-Appellees.

BEFORE: MERRITT, Chief Judge, NELSON, Circuit Judge, and Celebrezze, Senior Circuit Judge.

The court having received a petition for rehearing with a suggestion for rehearing en banc, and tne petition having been circulated not

only to tne members of the original panel but also to all other active judges of tnis court, and no judge having requested a vote on the suggestion for rehearing en banc, tne petition nas been referred to the original panel.

The petition asserts that the panel decision is contrary to the holdings of this court in Deckebach v. LaVida Charters, Inc. of Florida, 867 F.2d 278 (6tn Cir. 1989), and Curran v. Merrill Lyncn, Pierce, Fenner & Smitn, Inc., 622 F.2d 216 (6th Cir. 1980), aff'd on other grounds, 456 U.S. 353 (1982). The panel fully considered tne nolding in Curran upon the original submission and decision of tne present cases, and tne panel remains of the view tnat at this stage of tne ligita-

tion, at least, Curran is not dispositive. Deckebach was not cited in the original panel decision, and it is appropriate that we address Deckebach here.

The plaintiffs in Deckebach, a married couple, bought a yacht from La Vida Charters under a purchase agreement drafted by their own counsel. The Deckebachs' ultimate goal, after the yacht was paid for, was to use the vessel solely for personal purposes. To help finance the purchase, however, the Deckebachs entered into a management agreement with La Vida Management, an affiliate of La Vida Charters. The management agreement, which was terminable by either side on 60 days notice, provided that the management company would maintain the yacht and

arrange for its charter to third parties when the Deckebachs were not using it. La Vida Management had similar arrangements with the owners of other vessels, and as charter opportunities presented themselves, La Vida gave priority to vessels that had been available for the longest period of time.

The Deckebachs sued the La Vida company and others under the federal securities laws. On motion for summary judgment, the district court concluded that the arrangement for purchase and management of the yacht did not come within the statutory definition of a "security." This court, conceding that the case presented "a difficult and close question of law," 867 F.2d at 284, affirmed the district court's

judgment.

The instant litigation also presents close and difficult questions. Viewing the matter in the light most favorable to the plaintiffs, however, as we must do because the complaints were dismissed under Rule 12(b)(6), Fed.R.Civ.P., it seems to us that the lawsuits against Philatelic Leasing, et al. come a good deal closer to the Supreme Court's citrus grove case, SEC v W.J. Howey Co., 328 U.S. 293 (1946), than the Deckebachs' lawsuits against the La Vida companies did.

The Deckebach panel stressed that the citrus grove enterprise in Howey was partly owned by the defendants, and the financial success of the individual investors was linked to the financial success of the defen-

dants. Tnat was not true in Deckebach, where "La Vida had no ownership interest in the various yachts...and failure of the La Vida business operation would not have caused the yacnt owners necessarily to fail and to lose use of their vessels." 867 F.2d at 283. In tne cases at bar, by contrast, defendant Philatelic Leasing did retain an ownership interest in the various stamp masters, and the evidence may well show that if the money taken in by defendant Dell Philatelic had been used to promote local stamps successfully, all investors would have benefited, along witn Dell and the entities witn which Dell was allegedly acting in concert. Conversely, of course, the failure of Dell/Philatelic Leasing to receive any significant revenues from

sales of the local stamps that were produced from the masters made it highly likely that all investors, regardless of their individual financial resources, would lose the substantial tax advantages that represented a principal inducement -- if not the principal inducement --for the leasing of the masters. There was no corresponding link among the yacht owners in Deckebach; "the success of the La Vida enterprise and its ability to attract charters had only an indirect impact upon the individuals contracing with La Vida." 867 F.2d at 283.

It is also significant that the plaintiffs in Deckebach bought their yacht for personal use; they admittedly wanted to have it available

"essentially at their complete discretion." Id. at 284. The Deckebach panel noted that this factor -- which has its analogue in United Housing Foundation Inc. v Foreman, 421 U.S. 837 (1975), where a contract to buy a cooperative apartment was held not to constitue a "security" --"distinguishes the case from the facts in Howey." Id. In Howey, the Supreme Court said that the investors had "no desire to occupy the land or to develop it themselves; they are attracted solely by the prospects of a return on their investment." 328 U.S. 299-300, as quoted at 867 F.2d 283. The investors in the present case, as we must assume at this point, likewise had no desire to take personal possession of the stamp masters or use

the masters themselves; unlike the plaintiffs in Deckebach, the plaintiffs here were attracted solely by the prospect of tax savings and a return on their investment.

The purchase of the yacht in Deckebach, as this court said in further distinguishing Howey, was not simply "an investment in a charter business, with ownership rights in the yacht being merely incidental." 867 F.2d at 284. The investment in stamp master leases, on the other hand, could well be found to have been an investment in a philatelic business, with leasehold rights in the masters being merely incidental.

The Deckebach panel conceded that "[f]inancing a yacht purchased by generating rental income depended, to

some extent, upon the availability of yachts together under common management," Id. at 283, but the panel discounted that aspect of the case because the management arrangement was "mandated only for a short period [i.e., 60 days]." But the distribution agreement that all but one of the plaintiffs in the present cases signed with defendant Dell Philatelic was terminable only after the fourth year. It is true that no investor was required to sign a distribution agreement with Dell, but no investor was required to sign a management agreement in Howey -- and a significant percentage of the investors in Howey did not sign such agreements.

On balance, it seems to us, Deckebach merely highlights the simi-

larities between the present litigation and Howey. We see no conflict between our prior decision here and the decision in Deckebach. The petition for rehearing is DENIED.

ENTERED BY ORDER OF THE COURT

/s/ LEONARD GREEN
CLERK

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF MICHIGAN
SOUTHERN DIVISION

JOSEPH M. NEWMYER,

Plaintiff, CASE NO. 86-CV-74937-DT

vs.

HON. BARBARA K. HACKETT

PHILATELIC LEASING, LTD., et al.,

Defendants. /

JOHN W. KWIATKOWSKI,

Plaintiff, CASE NO. 86-CV-74939-DT

vs.

HON. BARBARA K. HACKETT

PHILATELIC LEASING, LTD., et al.,

Defendants. /

JOHN C. COLLINS and TOBIN R. COLLINS,

Plaintiffs, CASE NO. 87-CV-70580-DT

vs.

HON. BARBARA K. HACKETT

PHILATELIC LEASING, LTD., et al.,

Defendants. /

MAGISTRATE'S REPORT AND RECOMMENDATION

RECOMMENDATION: Defendants' Motion to Dismiss Counts II, III, and IV of the instant Complaint should be granted as Plaintiffs have to show that their lease agreements were "securities" within the scope of the Securities Exchange Act of 1934 or that the subject program involved a "pattern" of racketeering within the scope of the Racketeer Influenced and Corrupt Organizations Act (RICO). The remaining (state law) claims should be dismissed, without prejudice, in light of the federal securities and RICO claims.

I. FACTS & PROCEEDINGS

Staffa, Bernera and Eyn Hollow are three privately owned islands located off the coast of Scotland; they are not

serviced by the United Kingdom Postal Authorities. In 1979 Crailheath Ltd., a U.K. corporation, entered into a series of agreements with the owners of the islands, under which the corporation was given the right to produce stamps bearing the names of the islands. Crailheath would pay $3.60 for each separate type of stamp it produced and would set aside a certain number of stamps for use by the island as local postage to transport mail between the island and the nearest British Post Office.

Crailheath then transferred the rights to produce these stamps to Defendant Global International, a Liberian corporation, for the same $3.60 per type of stamp (master), plus other undisclosed consideration.

Global then produced the necessary stamp masters to create the stamps, at an approximate cost of $1,000 per master.

On May 31, 1982, Global sold to Defendant Hambrose Stamps Ltd.[1] the right to produce up to 9,711 different stamp masters with the provision that only 75,000 stamps could be produced from each stamp master. The stamp masters produced perforated, imperforated, souvenir and deluxe stamps and came in two-stamp, four-stamp, six-stamp and eight-stamp masters. The purchase price for each master ranged

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[1] A New York corporation whose shares are wholly owned by Defendant M & J Holding Corporation; M & J, in turn, is wholly owned by Defendant Herman Finesod.

from $100,000 to $200,000,[2] payable with only between $1,800 and $2,500 cash down and a non-recourse, 9% note, due in 1996 (extendible to 2006), for the balance.

One day later, on June 1, 1982, Hambrose agreed to sell to Defendant Philatelic Leasing Ltd.[3] up to 9,500 of the stamp masters for prices ranging between $150,000 and $400,000. The purchase price was payable with only between $10,000 and $28,000 cash down and a 9% recourse note due in 1996 (extendible to 2006) for the balance.

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[2] E.g. $106,800 for a two-stamp master; $207,500 for an eight-stamp master.

[3] A New York corporation wholly owned by Defendant Melvin Hersch.

The notes were guaranteed by Defendant Hersch, who had a net worth at the time of only about $200,000.

In 1982 Philatelic purchased 830 stamp masters from Hambrose, executing $160,750,000 in notes (guaranteed by Hersch) and paying $7,010,000 in cash. The same year Philatelic prepared an Offering Memorandum, seeking to attract potential investors. The investors were told that they could lease a stamp master, produce and sell the stamps, obtain an investment tax credit for use against their personal income tax liability, and deduct lease payments, production costs, interest and other costs. The lease agreement provided that distribution and sale of the stamps produced would be the responsibility of the investor, who could

employ his own distributor. Philatelic would not designate or recommend distributors, but would furnish the

investor, upon request, with a list of distributors known to the company.

As part of the Offering and/or the promotional campaign, Defendant Friedman and Shaftan (a professional corporation of attorneys) provided a 50 page tax opinion, and they and Defendant Trager, Glass and Company (a professional accounting firm) stated they would assist the investors' attorneys and accountants if the Internal Revenue Service challenged the plan. Defendants McConnell, Pilgrim Stamp & Coin and Brubaker provided appraisals of the stamp masters, Defendant Boelter, Hopt & Gale (an attorney partnership) issued a newsletter to its subscribers touting the benefits of the Philatelic investment, and Defendant Dell Philatelic (and apparently its

sister corporation, Defendant Westminster Stamp Gallery) was among available distributors listed by Philatelic. Defendant Yeo (and his corporation, Defendant Continental Management) was a tax advisor and/or accountant for each of the Plaintiffs; although he did not inform them that he was also a salesman for Philatelic, he induced them to invest in the plan, provided them with the offering, opinions, appraisals and the Boelter newsletter, and recommended Dell Philatelic as a distributor.

In November and December 1982 the Plaintiffs invested in the Philatelic plan. In a typical investment for a two-stamp master, Plaintiff would lease the master for seven years, at an annual payment of $30,000. In the

first year, the investor would pay $1,500 cash at closing, giving a recourse note for $13,500 due in 1983 and a recourse note for $15,000 due in 1990; in the second year, he would provide one recourse and one non-recourse note for a total of $30,000, both due in 1990. In the third and subsequent years, payment of the annual charge was by one, $30,000, non-recourse note only, due in 1990. There was also an up-front fee of $2,000, and a 25% commission of gross sales receipts, payable to Dell Philatelic for its marketing and distribution of the stamps to the public.

A few years later, however, and after Plaintiffs had filed a number of tax returns seeking their anticipated benefits, the Internal Revenue Service

disallowed the investment tax credit and the deductions for the Philatelic investment, concluding that the scheme lacked economic reality or substance, that the stated value of the stamp masters was grossly inflated, and that the primary motive for entering into the plan was tax avoidance.

After the United States obtained injunctive relief against further offering of the Philatelic Leasing program, Plaintiffs filed, separately, the instant (almost identical) complaints against the (same) Defendants. Claiming, inter alia, that Defendants failed to disclose to them that the right to produce the stamps was originally purchased for only $3.60 per stamp, that Hambrose purchased the right to produce the stamps with a

nominal down payment and an enormous balance in non-recourse notes, that the sale from Hambrose to Philatelic was not an arms length transaction, that Hersch's guaranty of $160,750,000 in Philatelic notes was meaningless in light of Hersch's net worth of only $200,000, and that the Philatelic scheme was substantially identical to two other (Lithographic and Master Recording) tax shelters, both of which had already been denied credits and deductions by the IRS, Plaintiffs sought compensatory, consequential, exemplary and treble damages. The 12 Count Complaint contained two federal causes of action (Securities Fraud, Counts II and III; RICO, Count IV) and

a number of state law claims.[4]

Defendants have filed Motions to Dismiss contending, inter alia, that the Federal Securities and RICO Counts fail to state a viable claim and that pendent jurisdiction over the remaining state claims should be declined. Individual Defendants have also filed Motions to Dismiss or For Summary Judgment on grounds of an absence of attorney or accountant relationship, lack of personal jurisdiction, improper venue, and statutes of limitation. The matters were referred to the undersigned for Report and Recommendation and oral arguments were heard on July 29, 1987.

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[4] I-Common Law Fraud and Deceit; V and VI - Attorney Malpractice; VII - Accountant Malpractice; VIII and XI - Negligence; IX - Civil Conspiracy; X - Breach of Contract; XII - Exemplary Damages.

II. MOTION TO DISMISS COUNTS II AND III (SECURITIES FRAUD)

Defendants have filed a Motion to Dismiss Counts II and III, relating to Securities Fraud, on the grounds that the Court lacks subject matter jurisdiction because Plaintiffs' leases were not "securities" under the Securities Exchange Act of 1934. The Act defines "securities", inter alia, to include any "investment contract" and it is that definition upon which Plaintiffs rely to bring their action within the statute. 15 U.S.C. §78c(a)(10).

The Supreme Court has held that the basic test for distinguishing an investment contract of money in a common enterprise with profits to come solely from the efforts of others. United Housing Foundation v. Formen,

421 U.S. 837, 852 (1975), citing SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946). Accord, SEC v. Professional Associates, 731 F.2d 349, 352-353 (6th Cir. 1984). More particularly:

> The touchstone is [1] the presence of an investment [2] in a common venture [3] premised on a reasonable expectation of profits [4] to be derived from the entreprenurial or managerial efforts of others. By profits, the Court has meant either capital appreciation resulting from the development of the initial investment...or a participation in earnings resulting from the use of the investors' funds.... In such cases the investor is "attracted solely by the prospects of a return" on his investment.... By contrast, when a purchaser is motivated by a desire to use or consume the item purchased...the securities laws do not apply.

Foreman, Supra, 421 U.S. at pp. 852-853.

A. Common Enterprise

In the Sixth Circuit, a common

enterprise or venture exists only where "horizontal commonality" is shown. Union Planters National Bank v. Commercial Credit Business Loans, Inc., 651 F.2d 1174, 1183 (6th Cir. 1981), cert. denied 454 U.S. 1124; Curran v. Merrill, Lynch, Pierce, Fenner & Smith, 622 F.2d 216, 222 (6th Cir. 1980), aff'd on other grounds, 456 U.S. 353. As the Court has explained:

> Horizontal commonality ties the fortunes of each investor in a pool of investors to the success of the overall venture.... In fact, a finding of horizontal commonality requires a sharing or pooling of funds.

Union Planters, Supra, 651 F.2d at p. 1183; Hart v. Pulte Homes, 735 F.2d 1001, 1004 (6th Cir. 1984)

In the instant case, each Plaintiff leased his own, unique stamp master from Philatelic; no other lessee had any interest in his master and each

Plaintiff had no interest in the masters of the other lessees. The investment of each lessee would be profitable if, and only if, he were successful in selling the stamps and ancillary products printed from his master and that success was not tied in any way to the efforts of other investors or Philatelic itself.[5] There is thus clearly no common enterprise or horizontal commonality with respect to the stamp marketing aspect of the investment.

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[5] See Dahl v. English, 578 F. Supp. 17, 20 (N.D. Ill. 1983), finding no horizontal commonality in the sale of unique works of art in lithographic plate form to individual purchasers through different contracts at different times, where the success of each purchaser depended upon his own efforts to sell the products and not upon the efforts of the other purchasers.

Plaintiffs contend, however, that the plan was in substance only a tax shelter and that they were really only passive investors in order to realize the tax benefits. Viewed in that manner, their "success" was tied to the "success" of all investors to the extent that if the tax structure were accepted by the IRS, all investors "profited"; if the plan were disallowed by the IRS, they all lost their investment. More specifically, the lease payments to Philatelic from each investor would tend to increase the net worth of the company, which in turn would tend to validate the claimed value of all the masters (necessary for the high investment tax credit sought) in light of the substantial amount of recourse notes given by Philatelic in

payment for the masters.[6]

The undersigned is persuaded, however, that such a purported "pooling" of funds to enhance the net worth of the promoter and sustain the tax benefits is insufficient to constitute the required common enterprise under the facts of this case. First, it would appear that the fair value of any given master would be fixed (for purposes of determining the tax credit) at the time the seven year lease agreement was executed and would not depend upon the subsequent financial condition of the company (even if that

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6 See Kolibash v. Sagittarius, 626 F. Supp. 1173 (S.D. Ohio 1986), finding horizontal commonality under that rationale in a similar scheme involving the lease of master musical recordings.

condition did vary according to the number of investors).

Secondly, there is no allegation or showing tnat the investors' lease payments were, in fact, used, or were ever intended to be used, to shore up Philatelic's net worth. Because Philatelic was thinly capitalized and had no substantial assets of its own (Complaint, Para. 31), Defendant Hersch had to personally guarantee the company's promissory notes. While it is alleged that Hersch's own net worth was insignificant (compared to the amount of notes he guaranteed), there is no indication that any of the lease payments were going to him. Furthermore, as the New York District Court which enjoined the program at the request of the government found, after

all payments required of Philatelic under the plan were made, the company was entitled to keep only about 1% of the lease payments it received. U.S. v. Philatelic Leasing, Ltd., 794 F.2d 781, 784 (2d Cir. 1986). Thus, it cannot be said that there was any realistic "pooling" of the investors' money to maintain the value of each individual master, and there is a consequent lack of any common enterprise even if the plan is viewed solely in its tax aspects.

Plaintiffs also argue that there was a pooling of funds because the lease payments may have gone to pay office expenses, rents, salaries, commissions, promotional trips, defense of the New York litigation, and to consummate promises to defend tax challenges

to individual investors. However, such overhead expenses would have been for the benefit of the promoters, not the individual lessees, and would not have affected the "success" of any given investor. The undersigned also does not believe that an executory promise to provide tax or legal assistance, if requested, would be the kind of "sharing of funds" contemplated by the requirement of horizontal commonality.[7]

[7] Two other cases (in addition to Kolibash, supra) relied upon by Plaintiffs are distinguishable. In SEC v. Aqua-Sonic Products, 687 F.2d 577 (2d Cir. 1982), it was conceded that the investors expected business profits from the managerial efforts of others and the issue was whether the investors retained so much control over the sale of the dental cleaning products that their profits could not be said to have come solely from the efforts of others. See §II C, infra. In In Re Energy Systems, 642 F. Supp. 718 (E.D. N.Y. 1986) the language regarding tax benefits was dicta

B. Reasonable Expectation of Profits.

Plaintiffs all but concede that there was no reasonable expectation of profits (at least from the efforts of others) from the sale or marketing of their stamps, but maintain that "profits" were expected from the promised tax benefits. While Kolibash, supra, did find that tax benefits from the pre-investment structuring of the master recording plan could constitute "profits" from the efforts of others, the undersigned must respectfully disagree with that holding.

In Sunshine Kitchens v. Alanthus

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7 con't because the Court had already found horizontal commonality through the use of pooled funds in installing, servicing, and managing the subject energy conservation devices. 642 F. Supp. at p. 736.

Corp., 403 F. Supp. 719, 722 (S.D. Fla. 1975), the Court held that if the sole inducement for the investment is tax benefits, there is no expectation of "profits". The Court later explained that the tax benefits might be the sole inducement for the investment if there was also, in fact, a reasonable expectation of non-tax, business profits:

> Here, the profits which the plaintiffs expected to receive were to come from the sale of the estimated two million tons of coal which were to be mined from the Jade property. The fact that the tax benefits to be derived from this investment were an important consideration to the plaintiffs is not surprising or compelling. It would be an unwise investor, indeed, who invested in a venture without careful consideration of the tax ramifications of that investment. Moreover, tax benefits could be the sole reason why an investor would decide to make an investment or choose one investment over another. So long as there exists an expectation of profit, the tax consequences can properly be the inducement for, as

> well as an incidental benefit of, an investment.

Stowell v. Ted Finkell, 489 F. Supp. 1209, 1221 (S.D. Fla. 1980)

In the instant case, there is no allegation or argument that, in addition to the tax benefits, the investors had any reasonable expectation of business profits, and even the New York case against Philatelic found the transactions motivated solely by tax avoidance purposes with no independent legitimate economic or business substance. U.S. v. Philatelic, supra, 794 F.2d at pp. 786-767.

Furthermore, tax benefits should not be deemed "profits" because the tax credits or tax deductions have no intrinsic value by themselves; the economic benefit of the investor arises only if the investor can offset them

against other income which he has. If there is no such other income, the investor has gained nothing, and the undersigned does not believe that such a speculative possibility is what the courts mean when they require "profits" from an investment for securities purposes.[8]

C. From the Entreprenurial or Managerial Efforts of Others

Here again Plaintiffs argue that profits (tax benefits) under the plan were to come from the efforts of others (promoters, lawyers, accountants) in

[8] A similar rationale was used recently by the Supreme Court in holding that tax benefits did not constitute "income received" for purposes of determining reductions in damages awardable in a tax shelter securities fraud case, citing, inter alia, United Housing v. Forman, supra. Randall v. Loftsgaarden, ___ U.S. ___, 106 S. Ct. 3143, 3150, 92 L.Ed.2d 525 (1986).

defending and sustaining the plan against IRS challenge (in the New York litigation and, potentially although not actually, on behalf of individual lessees). However, the individual investors were not parties to the New York litigation and could have pursued their individual entitlements before the IRS and the courts on their own (which apparently some have, in fact, done). The obligation under the lease agreement to defend was contingent upon an IRS challenge and upon a request from an individual investor. Could one then say that the lease was a security if the IRS challenged the plan, but was not a security (no efforts of others) if no challenge was brought, or the individual elected to defend himself?

Furthermore, even if defending the tax integrity of the plan were deemed "efforts of others," those efforts do not appear to be entreprenurial or managerial in nature. The undersigned is persuaded that such concepts imply some type of continuing effort to generate income and would not encompass a contingent, ancillary agreement to defend the legal status of the investment.

For the above stated reasons, the undersigned does not find the necessary common enterprise, or reasonable expectation of profits derived from the entreprenurial or managerial efforts to others, to render the instant lease agreements "securities" within the Act and, accordingly, recommends that the Motion to Dismiss Counts II and III be

granted.[9]

III. MOTION TO DISMISS COUNT IV (RICO)

Defendants have also filed a Motion to Dismiss Count IV, which alleges violations of and seeks damages under the federal Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. §§1961-1968, for failure to state a claim under the statutes.

Plaintiffs' RICO claims are based upon 18 U.S.C. §1964(c) which provides that "any person injured in his business or property by reason of a violation of section 1962" may sue for treble damages, costs and attorneys'

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9 Two other District Courts have, for similar reasons, found the Philatelic leases not to be securities within the Act. Lakshmikanth v. Philatelic Leasing, Ltd., Slip Opinion, No. 3-83-0710 (MD. Tenn. 1983); Nakagawa v. Ellis & Ellis Associates, Fed.Sec.L. Rep.(CCH), ¶93,028 (D. Hawaii 1986).

fees. There are four possible violations of §1962:

> Section (a) prohibits any "person" who has received any income from a "pattern of racketeering activity" from using or investing such income in any "enterprise" which is engaged in interstate or foreign commerce.
> Section (b) prohibits any "person" through a "pattern of racketeering" from acquiring or maintaining any interest in any such "enterprise."
> Section (c) prohibits any "person" who is employed by or associated with any "enterprise" from conducting or participating in the conduct of the enterprise's affairs through a "pattern of racketeering activity."
> Section (d) prohibits any "person" from conspiring to violate subsections (a), (b) or (c).

A "pattern of racketeering activity" requires at least two (predicate) acts of "racketeering activity," §1961(5), which, in turn, are defined as any acts indictable under certain federal or state criminal statutes, including

federal mail fraud and wire fraud statutes. §1961(1)(B).

The Complaints in the instant case seek damages for violations of §1962(a) [Paragraph 85], §1962(c) [Paragraph 86] and §1962(d) [Paragraph 87].

A. Sufficiency of tne Injury Alleged.

Although Defendants do not seriously contend that Plaintiffs have failed to state an injury under subsection (c), they do argue that there are compensable damages alleged under subsections (a) and (d). It is argued that there is no injury under (a) because there is simply no way that Plaintiffs could have been damaged by what Defendants did with their money after receipt of the lease payments. As stated in Gilbert v. Prudential

Bache Securities, Inc., 643 F. Supp. 107, 109 (E.D. Pa. 1986):

> It is inconceivable that plaintiffs suffered any injury as a result of any violation of §1962(a) which might have occurred. The damages claimed by these plaintiffs were caused by the alleged pattern of racketeering activities, culminating in the challenged securities transactions; whether the defendants did or did not invest the proceeds in a business affecting commerce cannot have been causally related to any injury to plaintiffs.

The undersigned agrees with this contention. The underlying basis for Plaintiffs' claimed injuries was not what Defendants had done in acquiring the stamp masters (resulting in their inflated valuation) and their misrepresentations to Plaintiffs about those steps. The injury to the investors was really completed once the lease agreements were signed and was not the

result of what Defendants may have done with the money once received. Indeed, as Plaintiffs themselves have argued, if Defendants had used the lease payments to invest in, and enhance the net worth of, Philatelic, the investors probably would have benefited because there would have been a better chance to validate the claimed fair value of the masters. Accordingly, any claim for damages pursuant to a violation of §1962(a) should be dismissed.

Defendants also contend that there can be no injury under subsection (d) because the essence of a conspiracy is an agreement to commit an illegal act and one can be injured only by the acts, or conduct of another, not by a mere meeting of the minds. However, Defendants' argument is really that a

conspirary per se can never cause injury and it is clear that at least the statute, §1964(c), contemplates otherwise. Furthermore, a conspiracy also encompasses overt acts, which clearly can cause injury, and even an "agreeing" participant may enhance the ability of the other conspirators to damage the victims. Finally, Defendants cite to cases which stand clearly for the proposition advanced and there are cases which have held that damages may be recoverable separately for a conspiracy to violate the other parts of the statute. Oklahoma v. Children's Shelter, Inc., 604 F. Supp. 867, 869-870 (W.D. Okla. 1985); Joseph v. Algemene Bank Nederland, 592 F. Supp. 141, 147-148 (W.D. Pa. 1984). Plaintiffs have thus sufficiently

alleged an injury under subsection (d).

We turn, then, to the critical issues of whether Plaintiffs have sufficiently alleged, under §1962(c) and (d) that Defendant "persons" operated or conspired to operate an "enterprise" tnrougn a "pattern" of "racketeering activity."

B. The Acts of Racketeering Activity

Defendants contend that Plaintiffs have failed to plead the required predicate (mail and wire fraud) acts with sufficient particularity, and, as one court has held:

> Under 18 U.S.C §1961(1) and (5), a "pattern of racketeering activity" involves at least two acts of "racketeering activity" within ten years. Acts of "racketeering activity" are indictable acts, and allegations concerning them should be viewed in light of the hornbook law that a federal grand jury

> should return an indictment only where there is probable cause or a reasonable probability that a crime has been committed... . "Tnus, to properly plead an action under the treble damages provision of RICO, a party must allege two acts of racketeering with enough specificity to show there is probable cause the crimes were committed."

Bennett v. E.F. Hutton Co., Inc., 597 F. Supp. 1547, 1560 (N.D. Ohio 1984)

A mere conclusory statement of mail or wire fraud is not sufficient to ground a RICO claim and the general rule, particularly for those offenses, is that the complaint must state the time, place, parties and the contents of the alleged mailed or telephoned misrepresentations sufficient to show an intent to defraud. Van Dorn Company v. Central States Can Co., 623 F. Supp. 1548, 1555 (N.D. Ohio 1985); Bender v. Southland Corp., 749 F.2d 1205, 1215-1216 (6th Cir. 1984); Barker v.

Underwriters At Lloyd's, 564 F. Supp. 352, 356 (E.D. Mi. 1983); Grant v. Union Bank, 629 F. Supp. 570, 576 (D. Utah 1986).

The only factual allegations of mail or wire fraud in the instant Complaints are contained in Paragraph 83:

> In the course or and in furtherance of Defendants' scheme of fraud, they utilized, or caused to be utilized, the United States mails and the facilities for interstate wire communication on numerous occasions within a ten year period for the purpose of transmitting false and misleading promotional information concerning the Stamp Master securities. Defendants' repeated use of the United States mails and means of interstate wire communication to further their fraudulent securities scheme constitutes a pattern of racketeering activity within the meaning of 18 U.S.C. §1961 and §1962.

There is no mention of mailings or telephone calls anywhere else in the

Complaints and it is evident that the predicate offenses have been insufficiently identified and pled. However, given the otherwise detailed description of the scheme, it would appear Plaintiffs could supply the specifics and the undersigned would accordingly recommend that they be allowed to amend their Complaints to cure the defect, if the Court does not accept the suggested dismissal of the action contained elsewhere in this Report.

C. The "Enterprise" as Separate From Defendant "Persons".

Defendants next argue that Plaintiffs have failed to sufficiently separate the statutory entities of "enterprise" and "persons." That is, subsection (c) prohibits any "person" who is associated with or employed by

an "enterprise" from conducting the affairs of the enterprise through racketeering, and subsection (d) prohibits any "person" from conspiracy to violate, inter alia, subsection (c). Defendants maintain that these provisions necessarily require that the "person" (Defendant) claimed to be liable must necessarily be separate and distinct from the "enterprise" because a "person" cannot be employed by or associated with, or conspire with, himself or itself.

That a "person" may also not be the "enterprise" does appear to be the settled rule. Hirsch v. Enright Refining, 751 F.2d 628, 633-634 (3rd Cir. 1984); Rae v. Union Bank, 725 F.2d 478, 480-481 (9th Cir. 1984); Bennett v. Berg, 685 F.2d 1053, 1060-1062 (8th

Cir. 1982); Zahra v. Charles, 639 F. Supp. 1405, 1407 (E.D. Mich. 1986). However, most of the cases cited by Defendants, wnich dismissed RICO claims for failure to separate the entities, involved either one (individual or corporate) defendant or a corporate defendant and its employees, divisions or representatives; and it is evident that the courts were struggling with the tension between requiring interaction yet separation of the two concepts.

As the Court in Gaudette v. Panos, 644 F. Supp. 826 (D. Mass. 1986) observed:

> The statute requires a relationship between the person and the enterprise that in turn requires a separation between the two entities.
>
> At p. 841

And in United States v. Computer

Sciences Corp., 689 F.2d 1181 (4th Cir. 1982) the Court stated:

> We conclude that "enterprise" was meant to refer to a being different from, not the same as or part of, the person whose behavior the act was designed to prohibit, and, failing that, to punish. To be sure, the analogy between individuals and fictive persons such as corporations is not exact. Still, we would not take seriously, in the absence, at least, of very explicit statutory language, an assertion that a defendant could conspire with his right arm, which held, aimed and fired the fatal weapon. A corporation, in common parlance, is not regarded as distinct from its unincorporated divisions either.

At p. 1190

Yet, the statute clearly allows an "enterprise" to be a "group of individuals associated in fact although not a legal entity," 18 U.S.C. 1961(4), and it is this definition upon which Plaintiffs, here rely. In a case somewhat similar to the instant one,

investors brought actions against multiple entities allegedly involved in offering lease and service agreements regarding energy conservation devices to passive, inexperienced investors. Accepting the rule that there must be a distinction between the enterprise and the person, the Court concluded:

> Plaintiffs alleged that each of the individual defendants is a person under RICO, while asserting that the required enterprise consists of the scheme for selling the securities. As plaintiffs and defendants both note, the denomination of the scheme as the enterprise can and should be interpreted as a reference to the defendants as a group... . Under RICO, an enterprise need not necessarily be a legal entity such as a partnership or corporation, but may consist of "any union or group of individuals associated in fact" ... . Such associations-in-fact may consist not only of individuals, but of groups of otherwise legally separate corporations... . Moreover, an enterprise composed of an association-in-fact, even if made up entirely of individual defendants deemed to be §1961(3) "persons", is

> to be viewed for purposes of RICO claims as possessing a separate existence from its individual members... . In the case at bar, the various defendants constitute persons under RICO, while the interaction and relationship between these defendants with regard to the alleged scheme to sell securities comprises an association-in-fact enterprise separate and distinct from these individual persons. Accordingly, the Court holds that the Complaint adequately distinguishes between the "person" and "enterprise" elements of plaintiffs' civil RICO claims.

642 F. Supp. at pp. 740-741

Accord: Fustok v. Conticommoodity Services, 618 F. Supp. 1074 (S.D.N.Y. 1985); Nunes v. Merrill Lynch, 609 F. Supp. 1055, 1065 (D.Md. 1985); Austin v. Merrill Lynch, 570 F. Supp. 667, 669 n.2 (W.D. Mich. 1983).

In the instant case, the enterprise is all Defendants acting together to promote the stamp leasing program, but these Defendants, as "persons," include

numerous individuals, corporations and partnerships which are separated geographically and in occupational or business pursuits, mostly unrelated except for their participation in the leasing scheme. Conceptually, there appears to be no problem with their individual identities being merged or co-extensive with the leasing scheme and the undersigned is persuaded that the required statutory distinctions have been met.

Again, if the Court does not accept the recommended dismissal of the RICO count presented in the next section, Plaintiffs should be allowed, as they have requested, to amend the language in Paragraphs 85, 86 and 87 of the Complaints to plead the association-in-fact more clearly and consistently.

D. The Pattern of Racketeering

As noted above, all claims under the RICO statute require proof of a "pattern of racketeering," and the courts have struggled to agree upon precisely how much criminal activity is required, and to what degree it must be related (or not), to constitute a "pattern." Defendants contend that the Philatelic scheme, as pled, does not state a viable "pattern;" Plaintiffs, of course, contend that it does.

The Supreme Court in Sedima S.P.R.L. v. Imrex Company, 473 U.S. 479 (1985) recently addressed the issues of whether the predicate acts required prior criminal convictions of the Defendants and whether or not there had to be a separate "racketeering-type" injury to civil

plaintiffs. Although the Court expressly declined to decide when the predicate acts would be deemed to constitute a "pattern," at pp. 481, 500, it did offer the following observation:

> The implication is that while two acts are necessary, they may not be sufficient. Indeed, in common parlance, two of anything do not generally form a "pattern." As the Senate Report explained: "the target of [RICO] is thus not sporadic activity. The infiltration of legitimate business normally requires more than one 'racketeering activity' and the threat of continuing activity to be effective. It is this factor of continuity plus relationship which combines to produce a pattern."
>
> Fn. 14, p. 496

And Justice Powell in dissent quoted an ABA study:

> The "pattern" element of the statute was designed to limit its application to planned, ongoing, continuing

> crime as opposed to sporadic, unrelated, isolated criminal episodes.
>
> At pp. 526-527

Particularly in fraud cases, the courts have disagreed over whether the predicate criminal activity must occur in separate fraudulent schemes or can properly and sufficiently be present in only one such scheme. Chief Judge Pratt of our District has taken the former view:

> The requirement that the predicate acts must have occurred in different criminal episodes is consistent with Congress' intent to exclude isolated criminal conduct from RICO liability. See Sedima, 105 S. Ct. at 3285 n. 14. While it is true that Congress intended RICO to reach both legitimate and illegitimate enterprises, RICO ought not to be used as a basis for federal question jurisdiction in every 'garden variety' fraud case. As one court has noted, "most substantial business transactions involve two or more uses of the mail during negotiations. To hold that two [such] acts are sufficient to

> constitute a 'pattern of racketeering activity' would be to sweep into federal courts, under RICO, the great majority of actions for fraud in commercial transactions"... . This interpretation is also consistent with the plain meaning of the word 'pattern.'
>
> > True enough, "pattern" connotes similarity, hence the proper emphasis on relatedness of the constituent acts. But "pattern" also connotes a multiplicity of events: Surely the continuity inherent in the term presumes repeated activity, not merely repeated acts to carry out the same criminal activity. It places a real strain on the language to speak of a single fraudulent effort, implemented by several fraudulent acts, as a "pattern of racketeering activity."
>
> ...This court is persuaded by the reasoning of the post-Sedima courts adopting a rigorous definition of the term "pattern," and holds that separate acts in furtherance of the same criminal episode or transaction do not constitute a "pattern" of racketeering activity under RICO.

McIntyre's Mini Computer Sales v. Creative Synergy Corp., 644 F. Supp. 580, 584 (E.D. Mich. 1986) (citations

deleted)

Accord: In Re Evening News Association Tender Offer Litigation, 642 F. Supp 860 (E.D. Mich. 1986) (J. Feikens); Zahra v. Charles, 639 F. Supp. 1405, 1408 (E.D. Mich. 1986) (J. Pratt); Cincinnati Gas & Electric v. General Electric Co., 656 F. Supp. 49, 79 (S.D. Onio 1986).

The Courts of Appeals are split on the issue. The Eighth Circuit agrees with the separate episodes or schemes approach of Judge Pratt. Devries v. Prudential-Bache, 805 F.2d 326, 329 (8th Cir. 1986). The Second and Eleventh Circuits do not require any showing of separate episodes. U.S. v. Ianniello, 808 F.2d 184, 192 (2d Cir. 1986); Bank of America v. Touche-Ross

& Co., 782 F.2d 966, 971 (11th Cir. 1986). The Seventh Circuit has adopted a case-by-case approach focusing on a variety of factors.[10] Morgan v. Bank of Waukegan, 804 F.2d 970, 975 (7th Cir. 1986). The other Circuits have either been unclear in their approach or have not ruled on the question.[11]

Fully aware that most of the Courts of Appeals which have considered the

[10] Such as the number and variety of predicate acts and the length of time over which they were committed, the number of victims, the presence of separate schemes and the occurrence of distinct injuries.

[11] Morgan, supra, 805 F.2d at pp. 974-975. The Fourth Circuit has not adopted a particular test, but has held that one misleading prospectus reaching the hands of ten investors did not constitute a pattern. International Data Bank v. Zepkin, 812 F.2d 149, 154-155 (4th Cir. 1987). The Sixth Circuit does not appear to have addressed the issue at all.

question would probably rule otherwise, and that the cases which do require separate schemes factually involve much smaller operations, the undersigned is nonetheless persuaded that the approach by Judge Pratt is the better view. As one commentator has observed: "Given the prevalence of mail and wire fraud use in commercial transactions, it is difficult to conceive a business fraud case that does not involve a letter sent through the mails or the use of the telephone.[12] Thus, unless some limitations are placed on the statute, RICO could well result in the federalization of almost all common-law business fraud, a result the undersigned

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[12] Civil RICO and Its Application to "Garden Variety" Fraud Within the Sixth Circuit, N. Kentucky Law Review, Vol. 13, p. 488 (1987).

cannot believe Congress ever intended. To hold that separate criminal acts done in furtnerance of the same scheme are insufficient to constitue a pattern of racketeering, at least where there is no realistic threat of on-going or open ended criminal activity, is consistent with the statutory language and the legislative goals, and provided a necessary brake on the runaway application of the statute.

Altnough the Philatelic leasing program was extensive, it was still a single scheme with a single purpose.[13] Each Plaintiff leased his stamp masters

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13 The District Judge in the government's New York case observed that the entire scneme "constituted a simple conspiracy...to perpetrate a tax fraud." U.S. v. Philatelic Leasing Ltd., 601 F. Supp. 1554, 1555 (S.D. N.Y. 1985).

in a single transaction, on a single date, pursuant to the same Offering Memorandum, and each victim suffered the same type of injury (loss of tax deductions and credits).[14] Furtnermore, the scheme was not "open ended," with a "threat of continuing criminal activity," because Philatelic could only purchase up to 9,500 masters (Paragraph 31) and in fact only bought 830 of tnem to lease (Paragraph 32). And there were no other goods or services which the company, or the

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[14] Although it is probably fair to say that the "scheme" began in 1979 with Crailheath's purchase of the stamp rights and ended in 1985 when the government's injunction against future offerings, it appears that most investors leased their masters in 1982 and were notified of the disallowance of their tax credits within three years thereafter.

enterprise, ever proposed to offer.

Accordingly, the undersigned finds that Plaintiffs have failed to plead or show the requisite "pattern" of racketeering activity and respectfully recommends that Defendants' Motion to Dismiss Count IV be granted.

IV. STATE LAW CLAIMS

The remaining Counts are all based upon state law and the final question is whether the Court should exercise pendent jurisdiction and retain them for resolution. In United Mine Workers of America v. Gibbs, 383 U.S. 715 (1966) the Court held:

> It has consistently been recognized that pendent jurisdiction is a doctrine of discretion, not of plaintiff's right. Its justification lies on considerations of judicial economy, convenience and

> fairness to litigants; if these are not present a federal court should hesitate to exercise jurisdiction over state claims, even though bound to apply state law to them... . Needless decisions of state law should be avoided both as a matter of comity and to promote justice between the parties, by procuring for them a surer-footed reading of applicable law. Certainly, if the federal claims are dismissed before trial, even though not insubstantial in a jurisdictional sense, the state claims should be dismissed as well.
>
> At p. 726

Accord: Gaff v. F.D.I.C., 814 F.2d 311, 319 (6th Cir. 1987); Litka v. University of Detroit Dental School, 610 F. Supp. 80, 85 (E.D. Mich. 1985) (J. Pratt); Schieb v. Humane Society, 582 F. Supp. 717, 726 (E.D. Mich. 1984) (J. Joiner); Selman v. Manor Mortgage Co., 551 F. Supp. 345, 348 (E.D. Mich. 1982) (J. Feikens); Elson v. Geiger, 506 F. Supp. 238, 244 (E.D. Mich. 1980) (J. Cook).

The instant case presents state claims for common law fraud, negligence, breach of contract, civil conspiracy, attorney malpractice and accountant malpractice; it has individual defendants from Michigan, New York and Massachusetts and corporations, partnerships and businesses from New York, Delaware, Massachusetts, Washington and Liberia. Disposition of all of the nonfederal claims might well involve applying the law of more than one state and principles of the conflict of laws.

The undersigned perceives no sound reason for not applying the general rule that pendent jurisdiction should not be exercised where all of the federal claims have been dismissed prior to trial, and accordingly recom-

mends that the state law claims also be dismissed, without prejudice to their resolution by the appropriate state tribunals.[15]

For all of the foregoing reasons, it is therefore recommended that Defendants' Motion to Dismiss Counts II, III and IV be granted, with prejudice, and that Counts I and V - XII be dismissed, without prejudice. The parties are advised that any objections to this Report and Recommendation must be filed within ten (10) days after they are served with a copy, or within any

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[15] If the Court does not accept this Report and Recommendation and elects instead to retain one or both of the federal claims, the undersigned will prepare and submit a supplemental report on the remaining dispositive motions with respect to the state law claims.

extension therefore that Judge Hackett may allow, or further appeal from the Judge's acceptance thereof is waived.

/s/ THOMAS A. CARLSON
THOMAS A. CARLSON
UNITED STATES MAGISTRATE

DATED: 10/30/87

cc: Honorable Barbara K. Hackett
Joseph A. Ahern
Robert A. Hudson
Douglas G. Graham
Clayton F. Farrell
Thomas W. Elkins
Michael J. Barton
Kenneth E. Prather

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF MICHIGAN
SOUTHERN DIVISION

JOSEPH M. NEWMYER,

Plaintiff, CASE NO. 86-CV-74937-DT

vs.

HON. BARBARA K. HACKETT

PHILATELIC LEASING, LTD., et al.,

Defendants. /

JOHN W. KWIATKOWSKI,

Plaintiff, CASE NO. 86-CV-74939-DT

vs.

HON. BARBARA K. HACKETT

PHILATELIC LEASING, LTD., et al.,

Defendants. /

JOHN C. COLLINS and TOBIN R. COLLINS,

Plaintiffs, CASE NO. 87-DT-70580-DT

vs.

HON. BARBARA K. HACKETT

PHILATELIC LEASING, LTD., et al.,

Defendants. /

ORDER ACCEPTING MAGISTRATE'S REPORT AND RECOMMENDATION GRANTING DEFENDANTS' MOTION TO DISMISS COUNTS II, III, AND IV, WITH PREJUDICE AND COUNTS I AND V - XII WITHOUT PREJUDICE

This matter is before the court on plaintiffs' objections to the Magistrate's Report and Recommendation Issued October 30, 1987. Plaintiffs make thirteen (13) specific objections to the Magistrate's Report.

This court has thoroughly reviewed the files, briefs, and correspondence in this action and determines that the Magistrate's Report properly addresses each objection.

IT IS ORDERED that the Magistrate's Report and Recommendation is adopted as the opinion of this court.

IT IS FURTHER ORDERED that Defendants' Motion to Dismiss Counts

II, III, and IV With Prejudice is granted.

IT IS ALSO ORDERED that Defendants' Motion to Dismiss Counts I and V - XII Without Prejudice is granted.

/s/ BARBARA K. HACKETT
BARBARA K. HACKETT
UNITED STATES DISTRICT JUDGE

Dated: February 29, 1988

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF MICHIGAN
SOUTHERN DIVISION

EDWARD O'CONNELL,

Plaintiff,

vs.

CASE NO.
88 CV 73687 DT

PHILATELIC LEASING, LTD., et al.,

JUDGE HACKETT

Defendants. /

MAGISTRATE'S REPORT AND RECOMMENDATION

I. RECOMMENDATION:

It is recommended tnat tne Court grant the three pending Motions to Dismiss.

II. REPORT:

On September 15, 1988, tne District Judge referred for report and recommendation three pending Motions to Dismiss filed by all of tne defendants in the above-captioned case. The above-captioned case is in all respects

indistinguishable from the cases of Newmyer v. Philatelic Leasing, Ltd., et al., Case 86-CV-74937-DT, Kwiatkowski v. Philatelic Leasing, Ltd., Case 86-CV-74939-DT, and Collins v. Philatelic Leasing, Ltd., Case 86-CV-70580-DT. United States Magistrate Thomas A. Carlson filed Reports and Recommendations in these prior cases dated October 30, 1987 recommending dismissal of Counts Two, Three and Four of each Complaint with prejudice and dismissal of Counts One, and Five - Twelve (state law claims) without prejudice. After review of objections, the District Judge entered an Order Accepting the Report and Recommendation and granting the Motions to Dismiss. Plaintiffs in these three cases have taken appeals from these

Orders of Dismissal and their appeals are pending before the United States Court of Appeals for the Sixth Circuit. A prior lawsuit filed by this plaintiff, Case 87-CV-71373-DT, was also included in the group of cases dismissed by Judge Hackett upon the recommendation of Magistrate Carlson. The Order of Dismissal was later set aside because the defendants had not theretofore been served with process in that case. Plaintiff O'Connell refiled his action as of July 27, 1988.

Although certain of the Motions to Dismiss raise additional questions, such as statute of limitations and personal jurisdiction, I conclude that these additional issues need not be addressed at this time. A copy of Magistrate Carlson's Report and

Recommendation in those three cases is herewith attached as a copy of the Order of the District Judge accepting that Report and Recommendation. It is the recommendation of the undersigned Magistrate that this Report and Recommendation be accepted as the findings and conclusions of the Court with regard to the case at bar. It is the understanding of the undersigned Magistrate that should the District Court enter such an order, this case would join the prior three cases for appeal purposes before the Sixth Circuit on the underlying substantive issues.

The parties are hereby informed that objections may be filed to this Report and Recommendation within 10 days of receipt of a copy thereof as

provided for in 28 U.S.C §636(b)(1)(C) and that failure to file objections may constitute a waiver of any further right of appeal. United States v. Walters, 638 F.2d 947 (6th Cir. 1981) states that "a party shall file objections with the district court or else waive right to appeal." See Fed.R.Civ.P. 72(b); Local Sub-Rule C-4(b).

Respectfully submitted,

/s/ PAUL J. KOMIVES
PAUL J. KOMIVES
UNITED STATES MAGISTRATE

Dated: October 26, 1988

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF MICHIGAN
SOUTHERN DIVISION

EDWARD O'CONNELL,

Plaintiff, Case No.
88 CV 73687 DT

vs.

HON. BARBARA K. HACKETT

PHILATELIC LEASING, LTD.,
et al.,

Defendants. /

JUDGMENT

This matter is before the court on the parties' objections to the magistrate's report and recommendation issued by Magistrate Paul J. Komives on October 26, 1988. In that report the magistrate recommends that this court accept as the findings and conclusions of the court, with regard to the case at bar, the report of Magistrate Thomas A. Carlson dated October 30, 1987, which this court adopted on March 21,

1988, in cases numbered 86-CV-74937, 86-CV-74939, and 87-CV-70580.

For the reason that the above-captioned case is in all respects indistinguishable from these three (3) cases, this court accepts the recommendation of Magistrate Paul J. Komives.

Judgment of Dismissal with Prejudice is entered in this case as to counts II, III and IV. Judgment of Dismissal without Prejudice is entered as to counts I, and V-XII (state claims).

/s/ BARBARA K. HACKETT
BARBARA K. HACKETT
UNITED STATES DISTRICT JUDGE

Dated: November 29, 1988

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF MICHIGAN
SOUTHERN DIVISION

EDWARD O'CONNELL,

Plaintiff, Case No.
88 CV 73687 DT

vs.

HON. BARBARA K. HACKETT

PHILATELIC LEASING, LTD.,
et al.,

Defendants. /

ORDER DENYING PLAINTIFF'S
MOTION FOR RECONSIDERATION

On November 29, 1988, this court issued a judgment adopting the magistrate's report and recommendation and dismissing with prejudice counts II, III and IV of plaintiff's complaint, and dismissing without prejudice counts I and V - XII. On November 30, 1988, "Plaintiff was not aware of the Judgment being entered" and filed a motion for stay of pro-

ceedings pending the issuance of decisions in related cases now pending before the Sixth Circuit.

On December 13, 1988, plaintiff filed a motion seeking reconsideration of tne court's November 29, 1988 judgment. Plaintiff also sought to have the court grant plaintiff's motion for stay of proceedings. The asserted basis for plaintiff's motion for reconsideration is that "[m]uch time and money will be saved by counsel for both Plaintiff and Defendant in docketing this case before the Sixth Circuit." Plaintiff also stated tnat defendants have concurred in the motion to stay.

Defendants have submitted a reply in opposition to plaintiff's motion for reconsideration. In their reply,

defendants state that in light of certain acts on the part of plaintiff which are inconsistent with the terms of defendants' initial concurrence, defendants have withdrawn their concurrence in plaintiff's motion for a stay.

Local Rule 17(m)(3) states:

> Generally, and without restricting the discretion of the court, motions for rehearing or reconsideration which merely present the same issues ruled upon by the court, either expressly or by reasonable implication, shall not be granted. The movant shall not only demonstrate a palpable defect by which the been misled but also show tnat a different disposition of the case must result from a correction thereof.

As noted above, plaintiff's motion for reconsideration is sought to reduce the costs of a potential appeal. Plaintiff has not demonstrated a

palpable defect by which the court and parties have been misled, nor has plaintiff shown that a different disposition of the case must result from a correction thereof. Plaintiff has failed to persuade the court that reconsideration of its November 29, 1988 judgment is warranted. Therefore,

IT IS ORDERED that plaintiff's motion for reconsideration be denied.

/s/ BARBARA K. HACKETT
BARBARA K. HACKETT
UNITED STATES DISTRICT JUDGE

Dated: February 7, 1989

FILED
APR 12 1990
JOSEPH F. SPANIOL, JR.
CLERK

In The

Supreme Court of the United States

TRAGER, GLASS & COMPANY,
Petitioner,

vs.

Docket No. 89 1455

JOSEPH M. NEWMYER, JOHN W. KWIATKOWSKI, JOHN C. COLLINS and TOBIN R. COLLINS,
Respondents,

vs.

TRAGER, GLASS & COMPANY,
Petitioner,

vs.

EDWARD O'CONNELL,
Respondents.

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES SUPREME COURT

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QUESTIONS PRESENTED

I.

WHETHER THIS COURT SHOULD REVIEW A NON-FINAL ORDER OF AN UNITED STATES APPELLATE COURT?

II.

WHETHER THIS COURT SHOULD REVIEW ISSUES WHICH WERE NOT PROPERLY BEFORE EITHER THE DISTRICT COURT OR THE COURT OF APPEALS?

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STATEMENT OF THE CASE

In November of 1986, the first of the Respondents' Complaints were filed alleging, inter alia, violations of the Federal Securities Laws and the Racketeer Influenced and Corrupt Organizations Act ("RICO"). In response to these complaints, four of the Defendants filed Motions to Dismiss. Before any discovery was initiated, the lower court dismissed the Plaintiffs' Complaint, holding that the investments were not securities under the Securities Exchange Acts of 1933 [15 U.S.C. Section 771] and 1934 [15 U.S.C. Section 78aa and 78j(b)]. The lower court also held that there was not a requisite pattern of racketeering activity pursuant to the Racketeer Influence Corrupt Organization Act [18 U.S.C. Section 1962].

On appeal, the Sixth Circuit reversed and remanded the case to proceed to trial in accordance with its decision.

One of the Defendants, Trager, Glass & Company, has asked this Court to grant its Petition for Writ of Certiorari to reverse the decision of the Sixth Circuit Court of Appeals relative to the securities law issue only. Respondents argue that this Court should not exercise its discretionary power in granting Writ of Certiorari on this matter.

FACTS

Respondents, for purposes of this response, will accept Petitioner's version of the facts.

ARGUMENT

Petitioner seeks review of the lower court's interlocutory order pursuant to a Writ of Certiorari under 28 U.S.C. Section 1254(1). Jurisdiction to review judgments and decrees of the Court of Appeals by certiorari is to be exercised sparingly, and only in cases of gravity and general importance, or in order to secure uniformity of decision. *Hamilton-Brown Shoe Co.* v. *Wolf Bros. & Co.*, 240 US 251, 258 (1916).

I. THE DECISION OF THE SIXTH CIRCUIT IS A NON-FINAL ORDER AND THERE ARE NO CIRCUMSTANCES WHICH WARRANT THIS COURT'S REVIEW

Although a writ may issue on an interlocutory order, the Supreme Court will not exercise its jurisdiction "unless it is necessary to prevent extraordinary inconvenience and embarrassment to the conduct of the cause". *American Construction Company* v. *Jacksonville, T. & K. R. Co.*, 148 U.S. 372, 13 S.Ct. 758 (1893). In other words, only under the most extraordinary circumstances will the Supreme Court hear a non-final order. See, for example, *United States* v. *Nixon*, 418 U.S. 683, 94 S.Ct. 3090 (1974). An examination of the holding of the Sixth Circuit clearly indicates the inappropriateness of Supreme Court review in this matter.

In its Petition for Writ of Certiorari, Petitioner claims:

> "The Sixth Circuit Panel (J. Merritt, J. Nelson, J. Celebrezze) determined that Plaintiffs' investment in Defendant Philatelic Leasing's tax shelter program constituted investment in a security."

The Sixth Circuit determined no such thing. What the Sixth Circuit did do, however, was to afford the Plaintiffs an opportunity to have their day in Court. The Sixth Circuit, rather than make a determination that the investment *was* a security, simply stated that it would not rule out the possibility that the investments *could* be a security. The Opinion is replete with such references:

> ". . . and if the Plaintiffs in the present litigation are able to prove their cases, the committment given by the distribution company here . . ." (p. 17).
>
> ° ° °
>
> "Having read Philatelic's offering memorandum, however, with its glowing account of the popularity of stamp collecting, we cannot rule out the possibility that Philatelic investors hoped to realize 'profits' in the true sense of the term." (p. 20).

° ° °

"These are factual questions, again, and the Defendants may ultimately prevail on them. But such questions are not to be resolved against the Plaintiffs on Motions to Dismiss — at least not on the sort of record that is before us here." (p. 21).

° ° °

"We do not come to grips with the issue here, however, given the clear possibility that at a trial of these cases, or in summary judgment proceedings, the Plaintiffs may be able to show that their arrangements with Dell got them over the commonality hurdle". (p. 23).

The decision is clearly interlocutory. If there is an issue in this case which the Supreme Court should review, this review should occur after a properly developed record.

II. THE PETITION FOR WRIT OF CERTIORARI SHOULD NOT BE GRANTED BECAUSE THE PETITIONER IS REQUESTING THIS COURT TO EXAMINE ISSUES WHICH WERE NOT ADDRESSED BY THE SIXTH CIRCUIT COURT OF APPEALS NOR BY THE DISTRICT COURT FOR THE EASTERN DISTRICT OF MICHIGAN

The Petitioner requests that this Court settle the issue of Horizontal versus Vertical commonality as an element in the determination of whether the Philatelic investment was a security. The Petitioner points to the split in authority between the Circuits as a compelling reason for Supreme Court review. There may well be such a split in the circuits. However, that issue was not addressed either at the District Court level or by the Sixth Circuit and, therefore, may not be raised at this time.

In both the United States District Court for the Eastern District of Michigan, and the Sixth Circuit Court of Appeals, both the Plaintiffs and the Defendants acknowledged that horizontal commonality was required in the Sixth Circuit. Again, it should be noted that the Court did not hold that the Philatelic investments satisfied the commonality requirement, but rather held that it was not impossible for the Plaintiffs to satisfy this burden at trial.

It is axiomatic that issues not raised below cannot be raised for the first time before an appellate court, especially the United States Supreme Court. *New York Dock Co.* v. *S.S. Poznan*, 274 U.S. 117, 71 L.Ed. 955, 47 S.Ct. 482 (1927); *Adams* v. *Mills*, 286 U.S. 397, 76 L.Ed. 1184, 52 S.Ct. 589 (1932); *Minnich* v. *Gardner*, 292 U.S. 48, 73 L.Ed. 1116, 54 S.Ct. 567 (1934); *Lynch* v. *United States*, 292 U.S. 571, 73 L.Ed. 1434, 54 S.Ct. 840 (1934); *Zellerbach Paper Co.* v. *Helvering*, 293 U.S. 172, 79 L.Ed. 264, 55 S.Ct. 127, 35-1 U.S.T.C. Para 9003, 14 AFTR 688 (1934); *Prudence Co.* v. *Fidelity & Deposit Co.*, 297 U.S. 198, 80 L.Ed. 581, 56 S.Ct. 387 (1936); *McCullough* v. *Kammerer Corp.*, 323 U.S. 327, 89 L.Ed. 273, 65 S.Ct. 297, 64 U.S.P.Q. 7 (1945). Therefore, this Court should not grant certiorari review of the commonality issue.

CONCLUSION

This case is not one which the United States Supreme Court should consider hearing — at least not yet. In the unlikely event that the Supreme Court decides that the issues presented in the Petitions Writ of Certiorari are worthy of its consideration, this Court should examine these issues after a proper record has been established pursuant to normal discovery and trial. Therefore, the Respondents request that this Court deny the Writ of Petition for Certiorari.

Respectfully submitted,

STARK, REAGAN & FINKBEINER, P.C.

By: _____

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DATED: April 5, 1990